IN THE

United States Court of Appeals

For the Ninth Circuit.

No. 15,125

HARVEY L. WELLS and HARRY J. ALBERTSEN, on behalf of themselves and others similarly situated,

Appellants,

v.

J. C. PENNEY COMPANY, a corporation, and THE CHASE MANHATTAN BANK, a corporation (substituted for The Chase National Bank of the City of New York),

Appellees.

BRIEF FOR APPELLEES.

Appeal from Final Judgment of the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, JUDGE.

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Preliminary Statement.

In this action Appellants attack the validity of the Penney Company Profit-Sharing Retirement Plan for Management Staff (hereinafter usually referred to as the Plan). In 1940 the Penney Company with the approval of its stockholders adopted this Plan for its present and future store managers and central and branch office associates holding positions of responsibility. As Mr. Sams, then President of the Company, explained in his foreword in the booklet

which presented the Plan to eligible associates (Ex. 125), it was the result of years of study to meet the particular needs of the Company. The Plan includes provisions for benefits in the form of cash and annuities for all participants to be provided by Company contributions, participants' contributions, earnings of the Fund and dividends on the Penney Company stock held by the Fund under the Plan. It contains provisions for participants reaching retirement age to receive in addition shares of the Penney Company stock held in the Fund (Exs. 125, 127). As an essential part of the Plan, the Company, at the Plan's inception, sold to the Trustee 200,000 shares of its authorized and unissued stock for $30 per share when the market value was $80 per share (R. 116, par. 27) to be held and distributed pursuant to the terms of the Plan.

The Plan has been in continuous operation since 1940. When established, participants numbered 1,716. At the end of 1953 there were 1,955 participants. Between 1940 and December 31, 1953, 943 participants had left the Company before reaching retirement status (R. 231, par. 28) and had received credits totalling $13,169,736.56, of which $5,319,173.34 represented credits in excess of their own contributions (R. 239, par. 36). During the same period, 272 participants had left the Company upon reaching retirement status (R. 231, par. 28) and had received, in the form of annuities, credits totalling $10,981,476.76, of which $4,623,728.83 represented credits in excess of their own contributions (R. 240, par. 37). In addition to these credits, the Trustee had, by December 31, 1953, distributed to such retiring participants 101,920 shares of Penney Company stock held by it under the Plan, of which 7,163 shares were delivered prior to the three-for-one stock split in 1946 (R. 241, par. 40). The market value per share of such stock as of July 1 in each year is shown in the record (R. 119). Of the original 200,000 shares of Penney Company stock in the Fund, the Trustee on December 31, 1953, held 483,754 shares of such stock, split 3 for 1, with a total market value of $36,039,673 (R. 241).

The above facts briefly describe the magnitude and many years of operation of the Plan which Appellants seek to destroy.

Appellants assert that as former Penney Company associates they were "forced by their employer to become participants" in the Plan (Br. 2, 3). No issue respecting duress exists of record in this case. Employment by the Penney Company has been and is at will (R. 177, 178). The requirement of participation in the Plan is simply one of the conditions of employment for the management staff. Many benefits resulted from such employment (Hughes R. 349). As shown above, participation in the Plan results in substantial financial benefits to the participants. Personal contributions of participants are made solely from the liberal share of profits which they receive under their compensation contracts with the Company (R. 219, par. 9, R. 225, par. 15). As the trial court found (R. 245), "The Plan is generous and sound."

The liberality of the Plan is also demonstrated specifically by the fact that Appellant Wells, who resigned (Ex. 242) in 1948 at age 52, had total credits of $22,563.48, of which $13,929.70 were personal contributions and $8,633.78 were other credits (R. 171, 172, 246). Appellant Albertsen, who was discharged (R. 109) in 1950 at age 54, had credits of $52,967.81, of which $30,213.13 were personal contributions and $22,754.68 were other credits (R. 173, 174, 247).

Appellants' asserted cause of action depends on one false premise—that the Plan is invalid as a lottery, a wagering contract or tontine insurance policy, and therefore void. If that premise falls, their whole case falls. Their claim of relief also depends on one false premise—that the Penney stock held by the Trustee was purchased with the earnings and compensation of the 1940 and 1941 participants. On this premise they claim that there would be a resulting trust, if the Plan should be declared invalid.

The first premise goes to the merits; the second goes only to the relief. Neither is true.

Appellants center their fantastic charge that the Penney Plan is a lottery, wagering contract or a tontine insurance policy on the operative effects of its provision that only participants who continue in the service of the Company until they reach retirement status will receive shares of Penney Company stock. Participants receive all their other benefits under the Plan upon separation, regardless of when their service terminates, regardless of age at that time, and regardless of whether they quit, are discharged or die.

These other benefits are provided by contributions made by the participants out of the profit-sharing portion of their remuneration, contributions made by the Company, which are measured by its profits, dividends on the shares of stock held by the Trustee, and earnings of the Fund. The Plan thus extends to the area of benefits receivable upon retirement or earlier separation, the Company's long established policy of providing incentives through profit-sharing. The greater the Company's profits, the greater the Fund from which participants' benefits come. The greater the services of the individual participant, store manager or central or branch office associate—the greater his responsibilities, the harder he works, the more his store or the Company prospers—the greater will be his profit-sharing compensation, his personal contributions, his proportionate share of the Company's contributions measured by profits and of dividends, and, as a consequence, the greater will be his Plan benefits.

In addition, if a participant continues in service until retirement at age 60, he receives a number of the shares of the Penney Company stock held by the Trustee in the Fund. The exact number will depend on the ratio of that participant's personal contributions when he retires to the total personal contributions of all other participants at that time. The greater the value of his services over the years in relation to the value of the services of all other participants, as measured by that ratio, the more Penney Company shares (within the limits specified by the Plan) he will receive on retirement.

The false premise of Appellants that the Penney stock held in the Trust was purchased with the earnings and compensation of the 1940 and 1941 participants does not relate to the merits, but only to what the relief should be if they can prevail on the merits. As we show in detail below (Point IV), there is no basis for a resulting trust. The stock was sold by the Company to the Trustee in 1940 at a price which was only about 37½% of its market value at that time (a detail which Appellants overlook). The Trustee, in strict accordance with the Plan, borrowed from a bank the money to pay for the stock. The Trustee then paid off the loan out of funds in the Trust. It is true that the trust funds resulted in part from contributions made by participants, in part from contributions made by the Company, and in part from dividends on the stock so purchased (and it is freely conceded that the entire Plan constituted one of the terms of employment of the participants). But this does not change the fact that it was trust moneys, not participants' moneys, that paid off the loan incurred to purchase the stock. The cost of the stock on the books of the Fund, as shown in Point IV, will be entirely covered by Company payments, and dividends on the stock paid prior to September, 1941.

The purchase of the Penney Company stock was a wonderful investment for the Trust. It has yielded in dividends alone (in which participants have shared, including these Appellants before they left the service of the Company) far more than the original cost of the stock. The stock is an asset of the Trust and held, in accordance with the terms of the Plan, for the benefit of all participants, present and future.

I. THE PROFIT-SHARING RETIREMENT PLAN IS VALID AND LEGAL.

A. There Is No Merit to Appellants' Contention That Stock Is Distributed to Participants in a Manner Contrary to New York Law and Public Policy.

(See Appellants' Specifications of Error Nos. 1, 2, 3, and 5)

Appellants contend that the trial court erred in not finding that the Plan and Trust Agreement provide benefits contingent on the predecease, discharge and withdrawal of participants; they also contend that the trial court did not make any finding to the contrary (Specification of Error No. 1, Br. 15; Br. 20).

To the extent that this contention is directed to any alleged insufficiency in the findings it should be disregarded because the trial court entered detailed findings setting forth the provisions of the Plan, showing how the shares of stock are held by the Trustee, the participants entitled to receive them and the formula for determining the number of shares distributable to retiring participants, and concluded that the stock provisions of the Plan are valid and legal (R. 235, 236, 238 pars. 33 and 34, R. 241 par. 40, R. 242 par. 41, R. 244 par. 45, R. 250 and 251). These findings amply support the trial court's conclusion. See *Carr v. Yokohama Specie Bank, Limited,* 200 F. 2d 251, 254, 255 (9th Cir. 1952).

Appellants refer to the method used in determining the number of shares of stock to be distributed to each retiring participant (Br. 20). They incorrectly state that the amount of stock is determined by the ratio of a participant's credits to the credits of all participants, whereas the ratio used is that of participant's personal contributions to personal contributions of all participants (Ex. 125, Art. 10, pp. 29-30).

Appellants misinterpret the Plan when they attempt to make it appear that an increase in the percentage (i.e.

the percentage resulting from the foregoing ratio) of each remaining participant and therefore an increase in the number of shares to be received upon retirement is certain to result if the contributions of other participants who leave the Company are withdrawn (Br. 20-27). Such a result does not necessarily follow.

The Plan was intended to be and is a continuing Plan. The original Plan participants did not constitute a fixed class but Plan participants constitute an open-end class into which new participants enter to take the place of participants who retire or who leave the employ of the Company before attaining retirement status. New participants also enter the Plan as the operations of the Penney Company expand and the number of stores increases. There is a constant flow of participants into and out of the Plan. As stated earlier, in 1940, when the Plan was established, there were 1,716 participants. At the end of the year 1953, there were 1,955 participants. The number of new participants entering the Plan from 1940 to 1953 was 1,454 as against 1,215 leaving the Company on retirement or earlier separation (R. 231, 232).

Each participant contributes annually to the Plan 20% of his profit-sharing compensation for each year (33⅓% for 1940 and 1941), which compensation, in turn, depends primarily on his performance (R. 219 par. 9; R. 225 par. 15; Hughes, R. 348-350). Each participant's percentage (as stated above, the ratio of his contributions to the total of all participants' contributions) varies from year to year. The increases or decreases in any participant's percentage are the result of many factors arising from the normal operations of a business having the character and magnitude of J. C. Penney Company (R. 217, par. 6).

Some stores make larger profits than others. In general, the more efficient managers have the more profitable stores and accordingly receive the larger amounts of profit-sharing compensation. Such managers are promoted to larger stores; as a result their profit-sharing compensation, and, therefore, their contributions to the Plan, tend to increase

faster than those of other participants. The profits of an individual store, and, therefore, the profit-sharing compensation of the manager, may increase or decrease from time to time by reason of changes in the economic condition of the community in which the store is located, or may change by reason of enlargement, modernization or relocation of a store (Ex. 155, third page). As new stores are opened, the number of participants increases and, as the managers of these stores commence to make contributions under the Plan out of their profit-sharing compensation, the percentage of each other participant in the Plan is affected. When a store manager dies or leaves the Company's employ, another associate must be transferred to take his place. This may necessitate further moves in other stores. Fluctuations from year to year in the profits of the Company as a whole, and additions, promotions and other changes in assignments in the central and branch offices also result in changes in the profit-sharing compensation received by the respective participants in such offices and corresponding changes in the amount of their contributions to the Plan. The composite effect of all the foregoing factors determines the changes that take place from year to year in the percentage of each participant.

In general, over a period of years each participant's contributions will reflect the extent to which his services, measured either by the profits of the individual store managed by him or by the responsibilities assigned to him in the central and branch offices, are of value to the Company. Whether his percentage will increase or decrease, however, will depend not only on his own performance and his own contributions to the Plan, but also on the contemporaneous performances of approximately 1,900 other participants. Of the total number of participants, some are advancing faster than others; some may be retrograding.

That a participant's percentage does not necessarily increase from year to year by reason of withdrawals, is demonstrated by the following examples of cases where almost identical amounts of personal contributions pro-

duced decreased percentages, resulting in the issuance of fewer shares of stock.

Participant	Date of Retirement	Personal Contributions	Percentage	Shares Received
Wood (Ex. 72)	July 1, 1950	$34,329	.001343131736	604
Hotchkiss (Ex. 73)	July 1, 1951	$36,390	.001262215245	568
Hedenquist (Ex. 313)	July 1, 1952	$36,013	.001162615318	523
Lowry (Ex. 315)	July 1, 1953	$36,572	.001107257434	498

During this period (1950-1953) many participants withdrew from and many others entered the Plan (R. 167).

From the point of view of the individual participant, there is no way of determining in advance whether his percentage will be larger or smaller from year to year. The composite contribution potential of approximately 1,900 participants is as likely to be improved as it is to be impaired by reason of some participants withdrawing from the Company. That result would not be affected, one way or the other, by the fact that the withdrawing participants had not attained retirement status and so received no stock.

The percentage of a participant does not necessarily increase the longer he remains in the Plan. Sometimes it works the other way. For example when Mr. Binzen, who received identical compensation with Mr. Hughes while they were both participants in the Plan and made identical contributions to the Plan, retired in 1950 with total credits of $271,603.19, his percentage was larger than was Mr. Hughes' percentage when he retired in 1951 with total credits of $307,162.05. Mr. Binzen received 2,779 shares, and Mr. Hughes received 2,755 shares (Exs. 72, 73).

Appellants' statement (Br. 20) to the effect that the more participants who left the Company before 60, the greater the stock "awards" to remaining participants is misleading. It is of course true that any stock not issued

to retiring participants is held in the Fund for distribution to participants in the Plan who thereafter reach retirement status, regardless of when such participants enter the Plan. Any attempt to convey the impression that a limited or specific group of participants would benefit is unjustified. The Plan was formulated and presented to stockholders as one under which present and future associates would participate and under which shares of stock would be available, for dividend credits and for distribution to retiring participants, over a long period of years (Ex. 55).

1. The validity of the Plan including the foregoing stock provisions is established by its express approval by the Treasury Department and by many court decisions approving plans containing similar provisions.

On August 23, 1940 the Company transmitted the Profit-Sharing Retirement Plan, together with the Trust Agreement, to the Treasury Department requesting an official ruling that the Plan met the requirements for exemption as an employees' trust under Section 165 of the Internal Revenue Code of 1939 (Ex. 310). In a ruling in which the pertinent provisions of the Plan were reviewed, including the formula and provisions for distribution of the shares of Company stock only to participants reaching retirement status, the Commissioner of Internal Revenue concluded that the Plan qualified under Section 165, stating in part (Ex. 310):

> "Based on the foregoing it is the opinion of this office that the Profit-Sharing Retirement Plan of J. C. Penney Company is an employees' trust under Section 165 of the Internal Revenue Code. The income of such trust is exempt from the Federal Income Tax."

Subsequent to the amendment of Section 165 by the Revenue Act of 1942, the Treasury Department on or about December 21, 1944 issued a ruling that the Plan met the

requirements of Section 165(a) of the Internal Revenue Code as amended and therefore qualified as an employees' trust entitled to exemption from Federal Income Tax. The Treasury Department has also determined that amendments to the Plan submitted to it from time to time did not affect the Plan's continued qualification as an employees' trust entitled to exemption from Federal Income Tax under the applicable provisions of Section 165 of the Internal Revenue Code, and the Plan has so qualified at all times since its adoption (R. 232, 251).

The approval of the Plan by the Treasury Department is highly persuasive of its validity.

The validity of the Plan is further indicated by many rulings and cases expressly approving reallocation of actual forfeitures under employee benefit plans of other companies. Before considering these authorities it should be noted that in the Penney Company Profit-Sharing Retirement Plan there is no forfeiture. No stock is credited to any participant's account at any time (R. 235). All stock is held in the Fund for distribution only to those participants who reach retirement status. A forfeiture presupposes the existence of a right which can be forfeited. Here neither the estate of a deceased participant nor a participant separating before reaching retirement status had any right to receive stock which could be forfeited.

Even if there were some merit in Appellants' contention (R. 180) that "forfeiture" resulted from the failure of participants leaving the Company before attaining retirement status to receive stock, no invalidity would therefore attach to the Plan. In profit-sharing plans (as distinguished from pension plans where benefits must be actuarially determined) reallocation of forfeitures is permitted. The only limitation on reallocation of forfeitures in connection with a profit-sharing plan is that such reallocation shall not be discriminatory in favor of officers, shareholders, supervisors, or highly compensated employees. The Penney Plan involves no such discrimination. (See pages 44 et seq. below.) Rev. Rul. 33, C. B. 1953-1, 267, 280, provides in part as follows:

"(1) *Application of forfeitures.*—Funds under a qualified plan arising from forfeitures because of termination of service, or other reason, must not be allocated to the remaining participants in a manner that will effect the prohibited discrimination. In a pension plan, this requirement is met by complying with the rule regarding definitely determinable benefits, to wit: 'Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer.' Similarly, in a stock bonus or profit-sharing plan the contribution formula may provide that forfeitures be used to reduce the employer contributions which would otherwise be required by the formula, but such application of forfeitures is not mandatory in such plans. Nevertheless, it should be observed that whatever provision is made for absorbing forfeitures under a stock bonus or profit-sharing plan the prohibited discrimination must not result."

In an article "Discrimination Problems in the Drafting and in the Operation of Pension and Profit-Sharing Plans" by Emanuel L. Gordon, New York University Fourteenth Annual Institute on Federal Taxation (1956) page 1153, the author states (p. 1173):

"Under both the old (Reg. 118 par. 39.165-1(a)(2)) and the proposed (Prop. Reg. 1.401-1(b)(1)(ii)) regulations, the employer's contribution to the plan (if there is one in the year in question) must be allocated to participating employees in accordance with a fixed formula. Even under the old regulations, however, forfeitures might have been used to reduce contributions called for by the formula, although normally they were reallocated among the remaining participants. Clearly, the employer's option as to handling forfeitures continues under the proposed regulations."

In an article "Advantages and Disadvantages of Pension, Profit-Sharing and Stock Bonus Plans: a Case Study" by Meyer M. Goldstein, New York University Fourteenth

Annual Institute on Federal Taxation (1956) page 1225, the author states (p. 1233):

> "It may be argued (and correctly) that forfeitures under a profit-sharing plan may be reallocated among the remaining participants thus increasing their distributive portions under the plan. That is so but only if the reallocation does not result in discrimination in favor of employees who are officers, shareholders, supervisors or highly compensated."

The "Specimen Profit-Sharing Plan and Trust Agreement" prepared by the Committee on Pension and Profit-Sharing Trusts of the Section of Real Property, Probate and Trust Law, American Bar Association, constituting the report of the Committee for 1947, appearing in *Prentice-Hall Pension and Profit-Sharing Service,* page 8163, provides (p. 8185, par. 9.7 referring to p. 8180, par. 6.8) that the amounts of any forfeitures shall be pro rated among the other members' accounts in the proportion which the amount of each member's account bears to the total of the amounts in all of the members' accounts.

In *Prentice-Hall Pension and Profit-Sharing Service,* page 4084, paragraph 4174, page 4084 it is stated:

> "*Use of forfeited interests.*— It is not unusual for plans to provide that employees' interests in the employer's contributions shall be forfeited at severance of employment, death or for other reasons. * * *
>
> "* * *
>
> "* * * The usual procedure under profit-sharing and stock bonus trusts is to use forfeited amounts to provide additional benefits for the remaining participants. * * *"

Ryan School Retirement Trust, Bank of America National Trust and Savings Association, Trustee, 24 T. C. 127, No. 17, April 29, 1955 (Acq. C. B. 1955-2, p. 9) involved a profit-sharing retirement plan where the amount of benefits an employee failed to receive (due to ceasing participation prior to the period prescribed for full benefits)

was to be reallocated among remaining participants serving the required period. Originally there were 115 participants, 5 of whom were officers. Initial contributions to the trust for the 5 officers amounted to $5,954.80 and for rank and file employees $70,676.27. As of October 31, 1951 there were 10 remaining participants, 5 of whom were officers, and the fund had been credited or distributed as follows: $52,603.80 had been credited to the accounts of the 5 officers; $19,134.32 had been credited to the accounts of the remaining 5 employees; and $19,075.36 had been paid out to terminated employees. The Tax Court held that there was no prohibited discrimination in favor of the officers and that the trust was exempt under 165(a) of the Internal Revenue Code, stating in part (No. 17, p. 8):

> "The respondent did not argue that the vesting provisions and the method of distributing forfeitures used here were inherently discriminatory. Those provisions, however, are the cause of the alleged discriminatory division of the trust funds. But such provisions as were present here would in any plan inevitably operate to give all permanent employees (including both officers and rank and file employees) a preferred position over that group of employees among which turnovers are frequent. If there is any discrimination here, it would seem to be in favor of the permanent employees as against the impermanent employees, but that is not the type of discrimination contemplated by the statute."

In *Commissioner of Internal Revenue* v. *Produce Reporter Co.,* 207 F. 2d 586 (7th Cir. 1953), affirming decision in 18 T. C. 69, the Court held that the two trusts involved were exempt under section 165(a). The Tax Court opinion disclosed that both trusts contained the following provisions:

> "6. That, in the event any Member resigns from the employ of said Company, said Member's interest automatically accrues to the benefit of all remaining Members, and will be promptly distributed to all such Members in the proportion that their term of con-

tinuous employment bears to the total terms of continuous employment of all other Members'' (18 T. C. 69, 71).

In *H. S. D. Co.* v. *Kavanagh, Collector of Internal Revenue,* 191 F. 2d 831 (6th Cir. 1951) the issue was whether contributions to two trusts for employees set up by the appellant were deductible in computing excess profits tax. The District Court held that the contributions were not deductible because of discrimination in favor of executive employees, two of whom were substantial stockholders of the corporation. The judgment of the District Court was reversed by the Court of Appeals. The District Court's opinion contains the following reference to the forfeiture provisions in the trusts (88 F. Supp. 64, 69):

> ''15. The rights of the employees under this plan were forfeitable at the time the taxpayer contributed thereto for the reason that the employees' trust agreement provided that when an employee voluntarily or involuntarily, left his employment with the company for any reason except cause (which is gross misconduct, dishonesty or insubordination) he would receive 10% of the contributions standing to his account for each year of service up to five years and 5% of such contributions for each year over five years and 100% of such contributions only at or after 10 years and the parties stipulated that the provisions of the Executive Trust Agreement, as amended, as to payment of benefits to beneficiaries and terminations were the same as provided for beneficiaries of the employees' trust.''

In passing on the propriety of the reallocation of forfeitures to remaining beneficiaries the Court of Appeals stated (p. 843):

> ''* * * As to the forfeitures, they were forfeitures to the trust itself. The trust agreement provides that no part of the trust funds can go to anyone except the beneficiaries. They received all of the benefits and assets. None of the assets of the trusts was forfeited

to appellant. The forfeitures above mentioned were forfeitures of a portion of the interest of specific beneficiaries which would occur under the terms of the trust, if they left the employ of the company within ten years. Such money would remain in the trust and would accrue to the benefit of the remaining participants. Neither appellant taxpayer or its executives or stockholders would profit thereby. The termination and forfeiture provisions of both trusts were identical; and, with respect to such provisions, all employees in both trusts have been treated identically. Neither the taxpayer nor the Trustee could control the operation of the termination and forfeiture provisions; and forfeitures occurred in both trusts.''

The case of *Schaefer* v. *Bowers,* 50 F. 2d 689 (2d Cir. 1931) involved a five year contributory stock subscription plan of the Standard Oil Company of New Jersey. Judge Learned Hand held that the plan was an exempt employees' trust under Section 219(f) of the Revenue Act of 1926, which was a predecessor of Section 165 of the Internal Revenue Code of 1939. The plan provided that if an employee's services were terminated voluntarily or if he was discharged for cause he was to receive only his own contributions back with interest, or at the option of the trustees an equivalent in shares, and the court stated (p. 690):

> ''Any shares or money accruing through withdrawals swelled the fund as a whole, and at its 'termination the fund shall forthwith be liquidated by the distribution of all the stock and cash therein to and amongst the then participants' * * *''

Even in situations where a trust for employees has not been qualified under Section 165 of the Internal Revenue Code the employer has been permitted to take a deduction for contributions to the trust without any criticism by the courts with respect to provisions of the trust for reallocation of forfeitures to remaining participants. See *Commissioner of Internal Revenue* v. *Surface Combustion Cor-*

poration, 181 F. 2d 444, 445 (6th Cir. 1950); *Gus Blass Co.,* 9 T. C. 15, 45 (1947); *Harold G. Perkins,* 8 T. C. 1051, 1053 (1947); *Julian Robertson,* 6 T. C. 1060, 1063 (1946); and *Gisholt Machine Co.,* 4 T. C. 699, 702 (1945).

In the *Gus Blass Co.* case referred to above the Tax Court stated with respect to reallocation of forfeitures as follows (p. 45):

> "* * * The agreement not only states that the fund is for the sole and exclusive benefit of the employees, without any right of reverter in the petitioner, but also, with respect to employees who might forfeit their their rights therein by leaving the employment, it provides that the shares allotted to them shall be distributed among the remaining employees."

In the case of *Harold G. Perkins, supra,* the Tax Court summarized provisions relative to reallocation of forfeitures as follows (p. 1053):

> "A trust indenture in accordance with the resolution was executed on September 30, 1941. It provided that if any beneficiary, within five years from the date of the creation of the trust for his benefit, should voluntarily leave the employ of Nash, except on account of illness or incapacitating disability, or if within that period his employment by Nash should cease through fault of his own as determined by the advisory committee, then the amount of benefits which he should be entitled to receive from the payments by Nash should equal one-half of that property held for his benefit in the trust. Any portion not paid to him was to be held for the benefit of the other trust beneficiaries. The trust beneficiaries had the right to designate death beneficiaries under any contracts of insurance held for their benefit."

2. The New York State Legislature has authorized numerous public pension or retirement plans providing benefits contingent upon service during a specified time or until a specified age.

An example of the type of legislation last above referred to is the State Teachers Retirement System for Public

School Teachers, 16 McKinney's Consolidated Laws of New York, Education Law, Part 1, (Sections 510, 511, 512, 516, 517) which is a contributory plan providing benefits after service for a specified period or to a given age. If an employee withdraws or dies before satisfying the service or age requirements he or, in case of death, his estate, receives no benefits under the plan, but receives only the amount of the employee's contributions.

For other illustrations of plans authorized by the legislature where benefits are contingent on service as above indicated, see: Retirement Of Officers And Employees By The Justices Of The Appellate Division, First Department (29 McKinney's Laws, Judiciary Law, Section 108); Retirement Of Officers And Employees By The Judges Of The County Court of Kings County (29 McKinney's Laws, Judiciary Law, Section 207); Retirement Of Officers And Employees By The Judges Of The Court Of General Sessions Of The County Of New York (29 McKinney's Laws, Judiciary Law, Section 208); Retirement Of Officers And Employees In the State Civil Service (9 McKinney's Laws, Civil Service Law, Art. 4, Sections 58, 61).

The case of *Matter of Bristol,* 93 Misc. 626, 158 N. Y. S. 503 (1916), affirmed 173 App. Div. 545, 160 N. Y. S. 410 (1916), involved the Yonkers Public School Teachers' Retirement Fund held by trustees. The fund was made up of the following: donations, legacies and gifts; 1% per annum of teachers' salaries; 5% annually of excise moneys received by the City; and:

> "*Fourth.* All forfeitures or deductions of or from the salaries of those in the service who are members of the association." (p. 629)

In passing on the rights of the participants in the fund in the possession of the trustees, the Court held that the members acquired no vested right in the funds and that until reaching retirement status their interest in the fund was a mere expectancy.

These plans for public employees show that the public policy of the State of New York sanctions provisions in pension or retirement plans which provide for forfeitures swelling the pension or retirement fund.

Similarly, under the act providing for Retirement of Civil Service Employees (5 U. S. C. A. Sec. 691 *et seq.*) compulsory deductions of a certain per cent of employees' salaries are made and paid over to the Civil Service Fund, and the fund including earnings thereon is used to provide annuities on retirement or specified disability. In the event of the death of a participant before the prescribed minimum service period, he forfeits all interest in the fund except the right to receive back the deductions from his salary with interest thereon.

3. (a) The Penney Profit-Sharing Retirement Plan does not involve life insurance and bears no resemblance to a tontine life insurance policy.

There is no basis for Appellants' argument that the Plan is subject to the New York Insurance Law, Section 146, relating to insurable interest, or Section 200, Subdivision 5, relating to retirement systems (Specification of Error No. 3, Br. 16; Br. 33). Here we are dealing with a profit-sharing retirement plan—not a life insurance policy. No participant obtains any insurance on the life of another participant. The Plan is not in any sense a contract of insurance, was not organized under the Insurance Law, and is not subject to that law. The inapplicability of the Insurance Law is shown by the case of *Colaizzi* v. *Pennsylvania Railroad,* 208 N. Y. 275, 101 N. E. 859 (1913) where the Pennsylvania Railroad was held not to be engaged in the business of insurance even though it maintained a contributory relief fund for employees under which benefits were payable upon disability or death.

There is nothing in the law which requires that the Plan be qualified under Section 200. Qualification under the provisions of this Section *is not in any sense mandatory.*

The group annuity contracts held by the Trustee under the Plan (Ex. 309) are of course subject to the approval of the Superintendent of Insurance in accordance with Section 154 of the New York Insurance Law.

Furthermore, even if Section 200 of the New York Insurance Law were in any way applicable to the Plan, no change would have had to be made in any of its features which are challenged in this action because, as stated above, the Plan is not an insurance contract, and the insurable interest requirement of Section 146 is not relevant.

Appellants attempt to impute invalidity to the Plan on the ground that it involves a tontine contract (Br. 32).

Tontine insurance is defined in *Richards on Insurance Law* (3rd Ed. 1915), Sec. 21, page 24, as follows:

> "A tontine policy is one in which it is agreed that certain accumulations or profits of the business shall be apportioned among those of the insured of a certain class surviving, at certain intervals; for example, every ten, fifteen, or twenty years. The lapsed policies of the class forfeit their reserve and dividends to the survivors. A tontine dividend is the distribution of such profits among the survivors who are entitled to it after the given period. A semi-tontine policy is one in which it is agreed that the dividends only shall be apportioned among the survivors of the class."

In the Penney Plan there is no fixed class, there is no specified period of time, there is no forfeiture, there is no accumulation of profits, insurance is not present, the purpose of the Plan is to compensate for services rendered and all Plan benefits are based upon services performed. It is apparent that the Penney Company Profit-Sharing Retirement Plan has no similarity to tontine insurance.

(b) Tontine life insurance policies have never been declared wagering contracts in New York.

Contrary to Appellants' assertion (Specification of Error No. 3, Br. 16; Br. 33, 34), no decision in the State of New York has been found which holds that a tontine

insurance policy constitutes a wager or gambling contract. In fact, rights and obligations under contracts of insurance issued prior to 1907 containing provisions for tontine accumulations were regularly enforced in the courts of the State of New York. *Simmons* v. *New York Life Insurance Company,* 38 Hun. 309 (N. Y. Sup. Ct. 1885); *Bogardus* v. *New York Life Insurance Co.,* 101 N. Y. 328, 4 N. E. 522 (1886); *Uhlman* v. *New York Life Insurance Co.,* 109 N. Y. 421, 17 N. E. 363 (1888); *Columbia Bank* v. *The Equitable Life Assurance Society of the United States,* 79 App. Div. 601, 80 N. Y. S. 428 (1st Dept. 1903); *McDonnell* v. *Mutual Life Insurance Co.,* 131 App. Div. 643, 116 N. Y. S. 35 (1st Dept. 1909); *Langdon* v. *Northwestern Mutual Life Insurance Co.,* 199 N. Y. 188, 92 N. E. 440 (1910); *Danner* v. *Equitable Life Assurance Society of the United States,* 156 App. Div. 562, 141 N. Y. S. 442 (1st Dept. 1913); *Gadd* v. *Equitable Life Assurance Society,* 97 Fed. 834 (S. D. N. Y. 1899).

When the foregoing cases were decided gambling and lotteries were illegal in New York. The revised statutes of that State which went into effect in 1830 made all betting and gambling illegal. The New York State Constitution of 1846, Article I, Section 10, prohibited lotteries, and the revised Constitution adopted in 1894, effective January 1, 1895, provided in part as follows (Article I, Section 9):

> "* * * nor shall any lottery or the sale of lottery tickets, pool selling, bookmaking or any other kind of gambling hereafter be authorized or allowed within this State; and the Legislature shall pass appropriate laws to prevent offenses against any of the provisions of this Section."

For the history of these provisions, see *People ex rel Collins* v. *McLaughlin,* 128 App. Div. 599, 602, 603; 113 N. Y. S. 188, 190, 191 (1st Dept. 1908).

Furthermore, in view of the above decisions it is evident that tontine insurance was sanctioned by the New York Courts despite the existence of the common law rule recognized in *Ruse* v. *Mutual Ben. Life Ins. Co.* (1861), relied on

in Appellants' brief (32), requiring insurable interest as a condition to the validity of life insurance policies.

It is apparent that the New York Courts did not consider insurance contracts which contained provisions for tontine accumulations illegal as involving a lottery, wagering or gambling contract within the meaning of the foregoing constitutional and statutory provisions.

In 1906 the Legislature among other changes in the New York Insurance Law added a provision requiring annual apportionment of surplus. This had the effect of prohibiting issuance thereafter of insurance contracts containing provisions for accumulations of surplus in excess of one year. This amendment, applicable not *ab initio* but only to policies issued after January 1, 1907, was not adopted on the basis that such type of accumulation was considered as a wager but rather to prevent the building up of huge surpluses over long periods of time with respect to which there had been prevalent wasteful abuses by the insurance companies and lack of control over such abuses by the insured. This legislation, of course, has no application or relation to the Penney Plan. The background of this legislation is described in *Richards on Insurance Law,* (3rd Ed. 1915) pages 17, 18 as follows:

> "In the United States, life insurance has attained a greater relative importance among financial institutions than in any other country. During the years which immediately followed the close of the Civil War, it grew with unparalleled rapidity; new companies were established in great numbers; new features of insurance contracts were devised, and soliciting agents canvassed the country from one end to the other. It is to be observed that fire policies on the average are for a much shorter term than life policies, and that a life company is ordinarily obliged to accumulate for the payment of future losses a much larger amount of assets than is required in the conduct of the business of marine or fire insurance, since, unlike the perils of shipwreck and fire, the peril of death is sure to occur sooner or later to the persons whose life is insured. Moreover, popular modern forms of life insurance

policies have involved the payment of deferred dividends of indefinite amount at stated periods in the distant future to fortunate survivors of a class.[2] The result followed that large life companies in this country,[3] in a wild race for supremacy among themselves, amassed enormous amounts of assets and surpluses which were not set aside for proposed betterments, or appropriated for present dividends, like the assets of a railroad or industrial corporation, or kept subject to call like the assets of a savings bank, but were retained for purposes which only the company's actuaries could fathom, a colossal trust fund which carried with it, especially to the officers and finance committees, temptations of an exceptional and subtle character. The machinery of the insurance departments proved ineffective to protect the policy holders from evil consequences of startling proportions, and after a notable investigation by a committee of the New York legislature, statutes of a drastic character were recently adopted in that state.[1]"

Footnotes—page 17: "(2) Tontine and similar forms, see Sec. 21.

"(3) Conspicuously the three great New York Companies, the Mutual, the Equitable, and the New York Life."

Footnote—page 18: "(1) N. Y. Law, 1906, c. 326. The Armstrong committee, the Hon. Chas. E. Hughes, counsel. The following results among others were accomplished by these laws affecting life insurance companies. 1. Policyholders given a more effective voice in the government of the companies. 2. Full publicity secured to policyholders in regard to management of companies' affairs. 3. Policies limited to four standard forms. 4. Policies safeguarded against forfeiture, warranties being converted into representations in absence of fraud. 5. Deferred dividend policies prohibited. 6. Companies obliged to make equitable distribution of surplus to policyholders at stated periods. 7. Investments regulated and control of subsidiary companies prohibited.—The New York court had decided substantially that upon maturity of his policy in a mutual company the policyholder could get for his share of the surplus only what the directors saw fit to divide. *Greeff* v. *Society,* 160 N. Y. 19, 54 N. E. 712, 46 L. R. A. 288, 73 Am. St. R. 659."

Appellants (Br. 34) rely upon the case of *Walker* v. *Walbridge,* 151 Misc. 329, 271 N. Y. S. 473 (1934) as authority for the proposition that the New York Courts have declared a tontine type of insurance policy null and void as a wagering contract. That case did not pass on the validity of a tontine accumulation, and in fact the court did not even mention the word "tontine". The *Walker* case involved an action on a note given by the defendant to C. W. Colgrove System, Inc. and assigned by C. W. Colgrove System to the plaintiff for collection. The note was given as a partial consideration for a contract between defendant and C. W. Colgrove System, Inc. whereby defendant agreed, in consideration of a like agreement by not more than 99 other subscribers, to take out a life insurance policy naming the Union Bank of Chicago as the beneficiary trustee for the first five years of the insurance policy. The agreement provided that in the event the insurance matured as a death claim within five years of its date of issue the trustee would administer the proceeds thereof by paying therefrom in full any indebtedness on said note to C. W. Colgrove System, Inc. and then paying 25% of the face amount of the insurance for the benefit of surviving subscribers to the C. W. Colgrove System, Inc. contract. The interest of each surviving subscriber was to be computed and based on the proportion that his first year's premium on the insurance bore to the total aggregate first year's premium of all surviving subscribers. The balance of the face amount of the policy was payable to the beneficiaries designated by the insured.

There was no purpose in entering into the Colgrove scheme other than to gamble 25% of the face amount of the life insurance policy against the hope of gain that would result from the prior death of other subscribers to the scheme. Participants do not enter the Penney Plan for any comparable purpose.

The court in the *Walker* case referred to the well settled principle of law that if a beneficiary, not selected by the insured, named in a policy of insurance has no insurable

interest in the life of the person insured then the transaction is a wager and void. The court then determined that the subscribers to the Colgrove System, Inc. contract had no insurable interest in each other and concluded (p. 337):

> "* * * this court comes to the conclusion that the other ninety-nine persons of the one hundred persons referred to in the contract and made the beneficiaries of the policy have no insurable interest in the life of the defendant herein and he has no insurable interest in their lives and, therefore, the transaction which included such policy and contract is void as being part of a wagering contract and against public policy."

The *Walker* case merely involved an attempt to make proceeds of a life insurance policy distributable in part to persons having no insurable interest in the insured, a problem not involved in determining the validity of the Penney Company Profit-Sharing Retirement Plan.

The cases of *Colgrove* v. *Lowe* and *Knott* v. *State* (Appellants' Br. 37-39) arising in Illinois and Florida both involved schemes similar to that in the *Walker* case.

Fuller v. *Metropolitan Life Ins. Co.* and *U. S. Life Ins. Co.* v. *Spinks* relied on by Appellants (Br. 41-43) are likewise not in point.

As shown by the digest in Appellants' brief, the Connecticut Supreme Court of Errors in the *Fuller* case reversed the lower court on the ground that error had been committed in admitting in evidence certain (expert) testimony. The court stated in that case by way of dictum that if plaintiffs' theory were accepted a wagering contract would be involved requiring dismissal of their complaint because a court of equity would not apportion the spoils of gamblers.

The *Spinks* case decided by the Kentucky Court, did not pass on the validity of tontine insurance under New York law. The principal issue was the proper interpretation of a provision in a New York statute relating to "dividend additions". The Kentucky Court incorrectly interpreted

this provision to mean a portion of the undivided surplus in the hands of the company. This incorrect interpretation was pointed out in a later New York case, *Fenster* v. *New York Life Insurance Company,* 188 Misc. 909, 910, 911; 66 N. Y. S. 2d 871 (1946) where the court stated that the term "dividend additions" refers to paid up additional insurance previously purchased with dividends and expressly rejected the *Spinks* case as having "no persuasive force".

The Penney Company Profit-Sharing Retirement Plan, conceived and operated as a plan to furnish retirement benefits for the management associates of the Penney Company, is not tontine insurance or an insurance contract lacking the requisite element of insurable interest, and is far removed from the type of contract contained in the *Colgrove* case, where the court stated (Appellants' Br. 28) that "the use of such a contract to promote the sale of life insurance presents an appeal to the gambling instincts of prospective policy holders that is contrary to sound principles of public policy."

4. The Plan does not violate New York constitutional and statutory provisions against wagering contracts and lotteries.

The parties are in accord that the law of New York is controlling as to the validity of the Plan and Trust Agreement (R. 178, 399, 400; Appellants' Br. 16).

Appellants contend that the Plan involves a wagering contract and lottery (Specifications of Error No. 3, Br. 16; Br. 46-53). It is difficult to understand the exact basis of their argument. From the record and their brief the alleged basis of their argument seems to be (1) the requirement of service to retirement status as a condition to receiving stock, and (2) that stock is not distributed to participants separating before reaching retirement status but remains in the Fund for distribution to participants who reach retirement status. Neither of these contentions provides any proper basis for their argument that the Plan

involves a wagering contract or lottery under New York law.

The New York Constitution, Article 1, Sec. 9, provides as follows (2 McKinney's Laws, Constitution, part 1):

> "No law shall be passed abridging the rights of the people peaceably to assemble and to petition the government, or any department thereof; nor shall any divorce be granted otherwise than by due judicial proceedings; no lottery or the sale of lottery tickets, pool-selling, book-making, or any other kind of gambling, except pari-mutuel betting on horse races as may be prescribed by the legislature and from which the state shall derive a reasonable revenue for the support of government, shall hereafter be authorized or allowed within this state; and the legislature shall pass appropriate laws to prevent offenses against any of the provisions of this section. As amended and approved Nov. 7, 1939, eff. Jan. 1, 1940."

The following sections of the New York Penal Law were not fully set forth in Appellants' brief (47):

> "Sec. 991. *Illegal wagers, bets and stakes.* All wagers, bets or stakes, made to depend upon any race, or upon any gaming by lot or chance, or upon any lot, chance, casualty, or unknown or contingent event whatever, shall be unlawful."

> "Sec. 992. *Contracts on account of money or property wagered, bet or staked are void.* All contracts for or on account of any money or property, or thing in action wagered, bet or staked, as provided in the preceding section, shall be void."

> "Sec. 1386. *Contracts, agreements and securities on account of raffling, void.* All contracts, agreements and securities given, made or executed, for or on account of any raffle, or distribution of money, goods or things in action, for the payment of any money, or other valuable thing, in consideration of a chance in such raffle or distribution, or for the delivery of any money, goods or things in action, so raffled for, or agreed to be distributed as aforesaid, shall be utterly void."

Sections 1370 and 1371 are fully set forth in Appellants' brief (48), except for the heading of each section, but are here set forth for convenient reference:

> "Sec. 1370. *Lottery defined.* A 'lottery' is a scheme for the distribution of property by chance, among persons who have paid or agreed to pay a valuable consideration for the chance, whether called a lottery, raffle, or gift enterprise or by some other name."
>
> "Sec. 1371. *Lottery unlawful and a public nuisance.* A lottery is unlawful and a public nuisance."

Under New York Law an act or omission is not a crime unless some statute of the State makes it so. *People ex rel. Blumke* v. *Foster,* 300 N. Y. 431, 433, 91 N. E. 2d 875 (1950); N. Y. Penal Law, Sec. 22 (39 McKinney's Laws).

Penal statutes of the character above quoted are to be construed strictly. In the case of *Federal Communications Commission* v. *American Broadcasting Company,* 347 U. S. 284, 74 S. Ct. 593, 98 L. Ed. 699 (1954), where it was held that "give-away programs" did not violate Section 1304 of the United States Criminal Code which prohibits the broadcasting of "any lottery, gift enterprise, or similar scheme, offering prizes dependent in whole or in part upon lot or chance," the Supreme Court stated in part (pp. 294, 296):

> "We believe that it would be stretching the statute to the breaking point to give it an interpretation that would make such programs a crime. * * *
>
> "It is true, as contended by the Commission, that these are not criminal cases, but it is a criminal statute that we must interpret. There cannot be one construction for the Federal Communications Commission and another for the Department of Justice. If we should give Sec. 1304 the broad construction urged by the Commission, the same construction would likewise apply in criminal cases. We do not believe this construction can be sustained. Not only does it lack support in the decided cases, judicial and administrative, but also it would do violence to the well-established principle that penal statutes are to be construed strictly."

See also *Metropolitan Life Insurance Co.* v. *Durkin,* 301 N. Y. 376, 93 N. E. 2d 897 (1950) where the court stated (p. 381):

> "* * * Such statutes, directed against known and stated evils, are not to be stretched to cover situations having no real or reasonable relation to those evils (see McKinney's Cons. Laws of N. Y., Book 1, Statutes 1942 ed., Secs. 95, 141, 146, and cases cited; also *Kauffman & Sons Saddlery Co.* v. *Miller,* 298 N. Y. 38, 44, 45, and *Matter of Breen* v. *New York Fire Dept. Pension Fund,* 299 N. Y. 8, 19). * * *"

(a) None of the evils intended to be suppressed by the constitutional provisions and statutes prohibiting lotteries and gambling or wagering is present in the Plan.

That the New York Penal Law which forms the alleged basis of Appellants' action herein has no application to the Penney Company Profit-Sharing Retirement Plan is obvious from an examination of the evils against which lottery or wagering statutes are directed as explicitly set forth by the courts.

In *Irving* v. *Britton,* 8 Misc. 201, 28 N. Y. S. 529 (Com. Pleas 1894), the court stated (p. 202):

> "By incorporating the interdict of lotteries in the Constitution and associating it with the fundamental guarantees of life, liberty and property, the people of New York signalize, by the most emphatic manifestation, their sense of the enormity of the evil they so seek to suppress. That evil consists in the temptation and facilities afforded by the lottery for the indulgence of the passion of gambling, and indulgence, by all experience, as inimical to the well-being of the state as of the individual. * * *"

In *People* v. *Mail and Express Co.,* 179 N. Y. S. 640 (Court of Special Sessions, 1919), affirmed without opinion in 192 App. Div. 903, 182 N. Y. S. 943, and 231 N. Y. 586, 132 N. E. 898, the court, in condemning a scheme for delivering prizes to holders of cards having the winning identifi-

cation markings, referred to the purpose of the lottery law, as follows (p. 642):

> "* * * Furthermore, it is argued that the precise mischief that the Legislature sought to correct is present in the transaction shown in this information; that not for any purpose of benevolence, but for gain derived from classes of persons easily subject to temptation and who can ill afford such use of scanty means of subsistence, the defendants developed and nurtured in those who yielded the perverted moral nature of the gamester, fascinated by hope and expectation of fortune's favor, which may give him without service or effort on his part the benefit of others' toil, thus engendering or increasing deteriorating and destructive emotional qualities, selfish greed, false standards of conduct, diseased sensationalism, and resultant slothfulness and dishonesty, and impeding the cultivation of wholesome character, the spirit of service and honor which makes the good citizen; that it would be unworthy of enlightened jurisprudence to allow the evident legislative intent of guarding the public welfare from the influence of this nefarious evil to be defeated by an ingenious device to evade the law by a mere variance of form of procedure, which leaves unchanged all the injurious effects."

The New York Court of Appeals in *People* v. *Gillson,* 109 N. Y. 389, 17 N. E. 343 (1888), stated (p. 404):

> "The right to legislate upon the subject of intoxicating liquors is acknowledged by every one, and is founded upon the fact that their use in excessive quantities leads, in large masses of cases, to crime, poverty and enormous suffering, and bears most harmfully upon the sum of the happiness of the human race. So in regard to lotteries in general. A wide spread custom of indulgence in the purchase of tickets leads, among the poorer classes certainly, and also among others, to habits of recklessness, waste and idleness; it cultivates a gambling spirit and tends to a hatred of honest labor, and to a desire to obtain riches or money without the necessary expenditure of industrious energy. * * *"

The evils inherent in a typical lottery have been set forth by the Supreme Court of the United States in *Stone* v. *Mississippi,* 101 U. S. 814, 25 L. Ed. 1079 (1879), where the court stated (p. 818):

> "* * * this court said, more than thirty years ago, speaking through Mr. Justice Grier, in *Phalen* v. *Virginia* (8 How. 163, 168), that 'experience has shown that the common forms of gambling are comparatively innocuous when placed in contrast with the wide-spread pestilence of lotteries. The former are confined to a few persons and places, but the latter infests the whole community; it enters every dwelling; it reaches every class; it preys upon the hard earnings of the poor; and it plunders the ignorant and simple.' * * *"

In an article entitled *"Insurable Interest In Life"* by Professor Edwin W. Patterson, 18 Col. L. Rev. 381 (1918), the author summarized the evil involved in wagering contracts as follows (p. 386):

> "* * * the chief objection [to a wagering contract] is that it leads to an unearned gain-'unearned' in the sense that wagering is not socially productive. It is difficult to define the objection, and it has seldom undergone judicial analysis. The harmful social consequences are numerous. Vaguely, a sense of antagonism is aroused in a community of workers against persons who obtain a means of livelihood without participating in the machinery of social or economic production and distribution—in short, against 'social slackers'. More specifically, unearned gains lead to idleness, and the wagerer becomes a social parasite. Useful business and industry are thereby discouraged. On the moral side, idleness leads to vice; and the impoverishment of the loser entails misery, and, in consequence, crime."

The trial court properly found that none of the evils enumerated in the foregoing authorities are found in the Plan, and that it does not: (1) encourage any passion for gambling, (2) take money from people who can ill afford to lose it, (3) encourage hope of gain without service or effort, (4) induce habits of waste and idleness and a hatred

of honest labor, (5) promote deterioration of moral qualities, or (6) discourage useful business and industry (R. 245). In short, the Plan, from the point of view of its business, economic and social consequences, is the very antithesis of the schemes sought to be eliminated by the lottery or gambling laws.

(b) The Plan does not have the essential elements of a wagering contract or lottery.

Appellants attempt to bring the stock provisions of the Plan within the prohibitions against wagering contracts on the theory that a lottery is involved (R. 88, lines 7-9; R. 189, par. 5; R. 204, par. 6; Appellants' Br. 48-53; Specifications of Error No. 3, Br. 16).

Under the tests established by the courts for determining what is a lottery, it is clear that neither the Profit-Sharing Retirement Plan of the Penney Company as a whole nor the provisions of the Plan relating to distribution of stock can be considered as constituting a lottery.

It is generally stated that the three essential elements which go to make up a lottery are (1) the distribution of prizes, (2) according to chance, (3) for a consideration. See *Federal Communications Commission* v. *American Broadcasting Company, supra.*

After an analysis of various decisions considering the essential elements of a lottery under New York law, the court in *Irving* v. *Britton, supra,* concluded as follows (p. 203):

> "From all the cases there are collected as the constituent elements of a lottery, namely: *First,* an expedient held out to the public, which, *secondly,* for a pecuniary consideration, offers the possibility and promise of a gain, not the product of the outlay, but contingent merely upon a designated chance event. As the name imports, the lot or chance is the essential property of the unlawful enterprise, and the allurement to the public the incident that aggravates its mischievous quality. * * *"

The New York courts have established that to constitute a lottery, chance must be the dominating and controlling element determining the result. In *People ex rel Lawrence* v. *Fallon,* 152 N. Y. 12, 46 N. E. 296 (1897) the court stated (p. 17):

> "* * * There is certainly a great difference between a contest as to the speed of animals for prizes or premiums contributed by others and a *mere lottery, where the controlling, and practically the only element, is that of mere chance alone.* A race or other contest is by no means a lottery simply because its result is uncertain, or because it may be affected by things unforeseen and accidental. * * * " (Italics ours)

Similarly, in *People ex rel Ellison* v. *Lavin,* 179 N. Y. 164, 71 N. E. 753 (1904) the court stated (pp. 170, 171):

> "* * * The test of the character of the game is not whether it contains an element of chance or an element of skill, but which is the *dominating element that determines the result of the game.*" (Italics ours)

In the more recent case of *People* v. *Hines,* 284 N. Y. 93, 29 N. E. 2d 483 (1940) a lottery is defined as being (p. 101):

> "* * * a scheme for the distribution of property in which a valuable consideration is paid on *chance alone, with no admixture of skill* * * *." (Italics ours)

It is significant that the basic decisions in New York stating the elements of a lottery arose in cases involving pool selling and book making (Irving), horse racing (Fallon), the numbers racket (Hines) and a guessing program for cash prizes (Lavin) which are far afield from matters of business administration such as profit-sharing retirement plans for employees.

The "suit club" and other merchandise and credit schemes involved in the cases cited by Appellants (Br. 50-53) bear no resemblance to a profit-sharing retirement plan, and furthermore, the inducement to enter into such schemes was the possibility of winning as a prize free merchandise

or cash based solely upon chance. Since this element of chance was the dominating factor, these schemes were held invalid.

Similarly, *State ex rel Home Planners Depository* v. *Hughes* (Appellants' Br. 50) involved a loan scheme where the opportunity to receive the loan was dependent on the day, hour and minute each application for a loan certificate was received in relation to all other applications for certificates. The court held this was a lottery because the opportunity to receive the loan was based entirely on such chance.

The Penney Plan was and is a profit-sharing retirement plan for the management staff of the Penney Company. The dominating and controlling factors determinative of benefits to participants under the Plan are their services to the Company and the success of the Company. Participation in the Plan is limited to eligible members of the management staff and forms an integral part of their employment relationship with the Company. The amount of each participant's contribution is determined by the amount of his profit-sharing compensation, each participant being required to contribute a uniform percentage of such compensation. Each participant's benefits upon retirement or other separation under the Plan are determined by the ratio of his personal contributions to the personal contributions of all other participants then in the Plan, and are, therefore, directly related to services rendered by each during the period of his participation.

Appellants place major emphasis upon the Plan requirement of continued employment to retirement age in order to receive stock (R. 189, pars. 5 and 6; Appellants' Br. 53). The uncertainty involved in this requirement is one which is inherent in connection with all employment relationships, namely, possibility of death or termination of employment for other reasons. This uncertainty is purely incidental and has no relation to the basic purpose of the Plan. That purpose is to provide on a profit-sharing incentive basis retirement benefits for members of the Company's manage-

ment staff who attain age 60 in the Company's employ and to provide generous additions to the savings of all other participants who do not attain such retirement status (R. 242, par. 42).

The Plan is characterized by certainties and not by uncertainties. Each participant knows that upon leaving the Company at any time, he will receive all credits to his account which include his own contributions, his share of Company contributions measured by profits and his share of dividends and earnings. He has the certainty that if he stays on to retirement status he will in addition receive shares of stock held by the Trustee for distribution to retiring participants. Termination of employment before age 60 because of death or disability results from uncertainties incidental to all aspects of life; leaving voluntarily or on discharge for cause involves an individual's own responsibility.

Appellants emphasize the Company's power of discharge (Appellants' Br. 27). In *Gardner-Denver Co.* v. *Commissioner of Internal Revenue,* 75 F. 2d 38 (7th Cir., 1935), the court made the following statement (p. 40):

> "* * * It is true that the employee might, if he chose, before the stock was paid for in the manner specified, have terminated the agreement and received back the money he had paid, with interest; and the employer might also, under the strict terms of the agreement, by discharging the employee have terminated the contract and relieved itself from further obligation thereunder.
>
> "But we do not believe that under the issues here there should be taken into consideration the possible contingency of the employer doing so harsh and inequitable a thing as to discharge the employee for the purpose only of preventing his completion of the specified payments and avoiding the obligation to convey to him the stock when paid for as specified. * * *"

The record in the present case contains no evidence whatsoever of any abuse by the Company of its power of discharge.

The "chance" of lotteries is not here present in the Plan. Participation in the Plan was mandatory. The advantages offered by employment with the Company (Hughes, R. 348, 349), together with the assured advantages from participation in the Plan, were so great, apart from the opportunity to receive stock under the Plan upon retirement, as to constitute the primary reasons for continuing in the employ of the Company. These circumstances are directly contrary to those in connection with a lottery or wagering scheme where ordinarily the very chance involved is the controlling and dominating factor that induces voluntary participation.

The uncertainty in connection with continuing in the Company's employment to age 60 is an incidental element of every day business life. The Company has retained competent management staff associates and of course has advanced them. Otherwise it could not have succeeded as it has. The possibilities that lead to termination of employment are not the kind of chance generally required to constitute a lottery or wager. The requirement that the "chance" involved be determined, not by factors such as those referred to above but by artificial forces, e.g., the draw of a ticket, the turn of a wheel, the throw of dice, is graphically illustrated in many cases, including the case of *United States* v. *McDonald,* 59 Fed. 563 (N. D. Illinois 1893), affirmed 63 Fed. 426 (7th Cir. 1894). Therein the court, in instructing the jury, stated (pp. 565, 566):

> "Now, every enterprise in which we engage has a return or prize, or is supposed to have. That is the incentive which makes men industrious and active. Whether that return or prize be determinable by mere lot or chance makes it either a legitimate enterprise, or a lottery, and therefore an unlawful enterprise. We perhaps can illustrate that best by referring to some of the schemes of life in which men are engaged. Take, for instance, the life insurance companies,—those that proceed either on the stock plan or on the assessment plan. They require of the member that he pay in a certain amount of money. That is the pecuniary con-

sideration. That money is invested, or supposed to be invested, in securities, and, when the member dies, a certain amount, stipulated in the policy, is paid to his heirs or the beneficiary named in the policy. That is the return. The man may have been insured but a month, and have paid in but a few dollars, and have received back $5,000 or $10,000. In such instances as that, a much larger sum has been returned than the consideration, but the fact that there was such a return does not make it an unlawful enterprise. Why? Because the prize is not determinable by, or dependent upon, chance or lot. It is dependent upon the life of a man, and the life of a man is determined by the laws of nature, and not by the chances of lot.

"A man who makes an investment in real estate may put in a few thousand dollars, and take out a million. What he puts in is the consideration; what he takes out is the prize. It may be a hundredfold larger than what he puts in, but on what is it dependent? Upon the growth of the town in which he lives; upon the growth of public sentiment respecting the value of property in that particular locality; upon the law of growth, which is itself a natural one,—an industrial law. But suppose a man puts a ticket in a hat with a hundred other tickets, and then it is drawn by a blindfolded man, his chance of the prize offered is dependent upon that drawing. The ticket may cost but 50 cents. The prize may be worth $10,—much larger than the price of the ticket, though not larger in proportion than the life insurance policy or the real estate investment. But the getting of the prize is dependent upon the chance or lot of his ticket being drawn, not upon any natural law, as a man's life, nor upon any industrial growth, as the growth of the value of real estate. This illustrates to you the difference between legitimate investments, which may yield, according to the good fortune of the investor, a hundredfold more than the amount invested, and a gambling investment, according to a lottery, which can only yield in case the allotment or chance, which is purely artificial, turns in his favor."

In *Eastman* v. *Armstrong-Byrd Music Co.*, 212 Fed. 662 (8th Cir. 1914) the court emphasized the type of chance

that must be found to characterize a transaction as a lottery, stating (pp. 666, 667):

> "While it is true that, if the scheme be a lottery, gift enterprise, or similar scheme, it is not necessary that it shall be determined wholly by chance, but if it rests upon a determination in whole or in part by chance it is sufficient, yet it must be first a lottery, gift enterprise, or similar scheme, and even then the word 'chance' is not used in its broadest signification. * * *
>
> "* * *
>
> "It thus appears that it is not every conceivable chance which makes a transaction illegal, and that the word 'chance,' as used in the statute, must be construed in connection with the word 'lot' and with the words 'lottery, gift enterprise, or similar scheme.' The maxim 'noscitur a sociis' applies, and the meaning of the word 'chance' is to be known or explained by its associates. * * *"

The necessity that artificial forces be the determining factor in relation to chance was further emphasized in the case of *United States* v. *Rich,* 90 F. Supp. 624 (E. D. Illinois, 1950), where the court stated (pp. 628, 629):

> "It would seem that the distinction between the risk or chance involved in a business venture and the lot or chance which enters into the determination of the awarding of a prize in a lottery, gift enterprise, or similar scheme within the meaning of the statute, as pointed out by Judge Grosscup in his instructions above quoted, [*United States* v. *McDonald, supra*], may properly be said to exist between the risk or chance involved in a wager upon the outcome of a horse race, a baseball game or an election and the lot or chance which enters into the awarding of a prize in a lottery, gift enterprise, or similar scheme. In the former natural forces are determinative, while in the latter artificial forces are determinative, at least in part. So it was that planned artificial forces thwarted skill and and caused the machine to be condemned as similar to a lottery under the laws of Massachusetts in *Commonwealth* v. *Plissner,* 295 Mass. 457, 4 N. E. 2d 241; the

chance drawing of cards determined the outcome of the game 'keno' and caused it to be condemned as a lottery under the federal statute in *Boasberg* v. *United States,* 5 Cir., 60 F. 2d 185; the business promoting offer of a right to 'pull' a chance of an advantageous purchase condemned as a lottery in *Wolf* v. *Federal Trade Commission,* 7 Cir., 135 F. 2d 564; the numbers game wherein the players merely guess that the result of mathematical calculations based on prices paid at a certain race track would be a certain prize-winning number held to be a lottery and not a direct bet on a horse race in *Forte* v. *United States,* 65 App. D. C. 355, 83 F. 2d 612, 105 A. L. R. 300; the promotion sale of foreign bonds through a chance of enhanced return dependent upon lot or chance determined by drawings held to be a lottery scheme in *Horner* v. *United States,* 147 U. S. 449, 13 S. Ct. 409, 37 L. Ed. 237 and in *United States* v. *Zeisler,* C. C. N. D. Ill., 30 F. 499; the investment scheme carrying with it a chance of obtaining a low number entitling applicant to a loan on attractive terms held to be a lottery in *United States* v. *Purvis,* D. C., 195 F. 618; the scheme for increasing subscriptions to a paper whereby all paid-up subscribers received numbered tickets corresponding to numbered coupons which were to be drawn from a box by a blindfolded person, with prizes to be given to holders of certain tickets held to be a lottery notwithstanding that every purchaser of a ticket is repaid his cost by receiving the paper in *United States* v. *Wallis,* D. C., 58 F. 542; are iilustrative of schemes which involved artificial forces affecting the awarding of prizes held to be lotteries by the courts. The awarding of the prizes was by 'lot' or by 'chance', used in a sense closely related to the meaning of 'lot' rather than by 'chance' as that term is involved in a wager on the uncertain outcome of games of skill, or of a horse race, or of an election, wherein natural forces are determinative."

Similarly, in *Matter of Dwyer,* 14 Misc. 204, 35 N. Y. S. 884 (Sup. Ct. 1894), where the court found that a horse racing stake was to be made up by entry fees and by additional sums added by the racing association, the court held that no lottery was involved, stating (p. 204):

"* * * It is not a lottery either in common speech or within legal definition. A lottery depends on lot or chance, such as the casting of lots, the throwing of dice or the turning of a wheel. In the scheme of this race, horse owners do not pay a sum to win a larger sum by lot or chance, but in order to enter into the contest of skill, endurance and speed upon which the stake depends. * * *"

It is manifest that the Plan does not involve a lottery or wager because no participant pays consideration for a "chance" to receive stock, a "prize", at age 60 in the sense that chance is used in the cases referred to above. If he performs services to age 60, he will receive, in addition to his other Plan benefits, stock as an agreed exchange for that service. Insofar as the stock receivable upon retirement is concerned, the participant who stays with the Company to age 60 furnishes consideration for the stock by serving the Company to that date. To the extent that there might be any slight increase in stock benefits to a retiring participant due to separation of other participants prior to reaching retirement status, it cannot be reasonably contended that such slight increase could even be a factor inducing participation in the Plan. The incidental possibility of such an increase is not the type of chance intended to be prohibited by statutes outlawing lotteries and gambling.

The words of the court in *Ledwith* v. *Bankers Life Ins. Co.,* (Appellants' Br. 68) are appropriate (p. 117):

"The retirement plan of the company and the benefits thereunder are a form of contingent deferred compensation for personal services of the employees and an integral part of the wage and salary structure of the Company."

B. The Stock Provisions Are Inseparable from and Constitute an Integral Part of the Plan.

(See Appellants' Specification of Error No. 6)

The trial court properly found that the stock provisions of the Plan are an integral part of the Plan and inseparable

from the Plan as a whole (R. 243). As shown above the Penney Company Profit-Sharing Retirement Plan cannot involve a wagering contract or lottery. The trial court properly concluded (R. 251) that the Plan is valid and legal whether the Plan be considered as a whole or whether, as Appellants contend, the provisions regarding stock be separated from the rest of the Plan—an excision which would violate the basic structure of the Plan. The stock received upon retirement constitutes the ultimate benefit designed to compensate participants who complete the full stipulated term of service to age 60.

There is no factual basis for Appellants' contention that the stock provisions should be viewed separately. The Plan was formulated and presented to stockholders as a means of inaugurating a compulsory retirement policy and to provide liberal benefits on retirement and earlier separation. It was also intended to constitute an improvement over the former outright sales of stock from time to time to associates (Ex. 55). The letter of Mr. Sams, then President of the Company, in presenting the Plan to stockholders, stated "Each participant in the fund will be a potential owner of Penney stock and constantly interested in its earning power but will not actually receive any stock unless and until he reaches the retirement age." (Ex. 55)

Dividends from the 200,000 shares of stock purchased by the Trustee from the Company, after payment therefrom of interest on the money borrowed to buy the stock and incidental Plan expenses not borne by the Company, were first applied, together with the Company's 2% of salary contribution for 1940, to cover the cost on the books of the Fund of the 50,000 share block of stock, which cost was covered in September, 1941 (R. 125). Thereafter all dividends were credited to the Dividend Account, and benefits distributed to participants on retirement or other separation have included their shares of the Dividend Account. Through December 31, 1953, $2,316,228.13 in dividends were distributed as benefits to participants who separated before retirement while participants reaching retirement

status had $2,124,514.63 in dividends applied toward the purchase of their non-assignable annuities (R. 139). Credits to the Dividend Account have totaled $17,329,025.32 (R. 138). These figures emphasize the important role dividends on the shares of stock held by the Trust have played in connection with participants' benefits. As compared with the total credits to the Dividend Account, it is interesting to note that the Company's contributions measured by profits under Article 6(b) of the Plan have totaled $17,986,969.84 (R. 138). The cost of the stock to the Trust was $6,000,000.

Appellants themselves contend "that the Plan and Trust Agreement constitute one instrument and are to be construed as a whole" (R. 190, par. 8). Appellees agree "that the Plan and Trust Agreement shall be read as an entirety" (R. 193, par. 8).

It is apparent from the early sales of classified stock (R. 94), from later sales of stock at favorable prices (R. 95-98), from Mr. Trown's letter dated November 24, 1939 considered at the Board of Directors' meeting of December 5 and 6, 1939 when the Plan was adopted subject to approval of stockholders (Ex. 2), from the Proxy Statement sent to stockholders prior to the Annual Meeting of March 21, 1940 together with Mr. Sams' accompanying letter (Ex. 55), from the purpose provisions of the Plan (Ex. 125, p. 22) and from the workings of the Plan, that the Plan would not have been adopted without its stock provisions.

The primary purpose of the Company in establishing the Plan could not have been served without the provisions relating to the stock (Hughes, R. 360-367). As Mr. Hughes said in his Statement on Retirement Before 60 Years (Ex. 227A), the 200,000 shares of Penney stock went into the Plan "as its basis and backlog."

None of the general propositions of law and none of the cases cited by Appellants (Br. 67-70) are authority or any justification for the attempt to sever an integral part of the Plan from the Plan as a whole for the purpose of judging that part by itself. All the provisions of the Plan, includ-

ing those for mandatory retirement, distribution of stock to participants reaching retirement status, use of dividends for the benefit of participants leaving the Company upon retirement or earlier separation, participants' contributions and Company contributions, constitute a unified structure. The Plan, without its stock provisions, would be emasculated.

II. ANY IMPLICATION BY APPELLANTS THAT THE DIRECTORS ACTED UNFAIRLY OR IN BAD FAITH IS UNJUSTIFIED.

Appellants made no specific contention in the Pre-Trial Order that the Directors acted at any time in bad faith. However, the implication of such a charge was so evident at the trial that the trial court felt it necessary to hold in its opinion, and to enter a finding to the effect, that there is no basis for attacking the integrity of the executive officers and members of the Board of Directors who were responsible for the adoption of the Plan and its administration (R. 212; R. 245, par. 49; R. 252, par. 14).

Apparently, Appellants' Specification of Error No. 2 (Br. 15, 16) is also intended to convey the implication of bad faith in view of their charge that the Plan was unfair, discriminatory and illegal because older employees (including some Directors who were executives) were among the first to qualify for retirement with stock and received a greater number of shares than younger and future employees will receive when they retire. Here again Appellants did not in any way attack the Plan on this ground in the Pre-Trial Order. The trial court in its opinion concluded that the fact that older employees, among them some members of the Board of Directors, who were among the first to qualify for retirement with stock, received a slightly greater number of shares than younger and future employees will receive when they retire, does not render the Plan unfair, discriminatory, fraudulent or illegal (R. 212).

Accordingly, the trial court entered a Finding of Fact and Conclusion of Law to this effect (R. 244, par. 46; R. 251, par. 13).

Appellants' Specification of Error No. 2 is apparently directed to the formula for distributing stock to retiring participants. The formula works in substance as follows: The number of shares of stock to be received by each retiring participant is determined by the ratio (percentage) which his contributions bear to the contributions of all participants. This ratio is applied to the 450,000 (split) shares and the resulting number so determined is distributed from the 150,000 (split) share block until exhaustion of that block. Upon such exhaustion distributions are made from the 450,000 share block. In determining the number of shares to be distributed from such block each participant's ratio is applied to the shares remaining in this 450,000 share block (R. 235, par. 31C). The Plan contemplates that younger and future employees will upon retirement receive larger credits, as a result of their longer participation, which will tend to offset the larger number of shares received by participants retiring earlier. The effect of the foregoing formula for distribution results in no discrimination whatsoever; rather it serves as a method of equalizing total benefits for retiring participants. Appellants nowhere show or intimate how this manner of distribution of shares of stock under the Plan could possibly render the Plan illegal, discriminatory or unfair. There cannot be any legitimate contention that the trial court was erroneous in finding as a matter of fact that: "There is a sound and logical basis for permitting employees who have not built up large credits for themselves under other provisions of the Plan to receive an advantage in connection with the distribution of stock under the formula set forth in Finding of Fact 31, subparagraph 'C'." (R. 244, par. 46).

Appellants cannot question the propriety of Penney Company executives receiving larger remuneration than

other associates. The annual personal contribution to the Plan of each participant is a uniform percentage of his profit-sharing compensation. Such compensation is determined as a matter of Company policy wholly apart from the Plan and is based on the value of his services to the Company. The stock benefits receivable on retirement as determined by the Plan formula are therefore directly related to the compensation received by each participant.

Directors who were executives were required, along with all other associates receiving compensation, to participate in the Plan (Ex. 125, p. 24). The deep-rooted and well tested policy of the Penney Company as shown by the executive positions held by the directors who served as such since 1939 (R. 98-109) was to have a Board composed of active executives and former active executives. This principle gave the Penney Company the management that from 1940 to 1950 trebled its sales (Ex. 155).

Appellants complain under the heading "Participation by Executive Group" (Br. 27) of the power of the Company officials to discharge employees and their failure to permit early retirements.

There is no evidence or claim by Appellants that the power of discharge was ever wrongfully exercised. As established in *Gardner-Denver Co.* v. *Commissioner* (*supra*, p. 35), the possibility of the company officials abusing that power should not be considered. Furthermore, there is no evidence in the record of any improper conduct on the part of the Board of Directors with respect to the provision for optional retirement in former Article 8(c) of the Plan which was eliminated by amendment in 1948 (Ex. 127, Sec. III, p. 5, Questions and Answers No. 24).

Under the heading "Participation by Executive Group" Appellants cite *Winkelman* v. *General Motors Corp.* (Br. p. 30). That case, a stockholder action, was concerned solely with the fiduciary obligation of directors to stockholders and has no relevance to the issues in this case. The directors amended a bonus plan so as to provide that forfeited bonus stock should revert principally to their benefit

instead of to the benefit of the corporation and stockholders. This action was taken without the consent of stockholders and was never reported to them either at any meeting or in the annual reports. The Court held in condemning such action that the directors had violated their fiduciary obligation to the stockholders.

III. THE TESTIMONY OF ALBERT W. HUGHES WAS PROPERLY ADMITTED IN EVIDENCE.

There is no merit to Appellants' Specification of Error No. 4 (Br. 16, 17) or their argument (Br. 53-60) that the trial court erred in admitting in evidence over objection certain testimony of Albert W. Hughes, President of the Penney Company. The witness was asked on direct examination:

> "Do you know the reason why there was included in the Profit-Sharing Retirement Plan the provisions for stock being issued to participants who left on the retirement age?" (R. 355)

Opposing counsel objected to the question on the ground that it was an attempt to vary the written Plan as adopted and was immaterial to any issue raised (R. 355, 356). Later, after Mr. Hughes, in answering the question, had given a substantial amount of testimony regarding the background of the Plan, opposing counsel interrupted, saying:

> "If your Honor please, the question asked of the witness is why they put stock in the Plan. We are now getting a lecture on the whole subject. I object to it as immaterial, *but if your Honor wants to hear it, it is all right with me.*" (R. 364) (Italics ours)

It thus appears that Appellants withdrew their objection, and accordingly this Court need give the matter no further consideration. In any event, there are other conclusive reasons why Specification of Error No. 4 is not well taken.

The parties are in agreement that the Plan constituted a contract between Penney Company and the participants

(R. 189, par 2; R. 191, par. 1). The testimony of Mr. Hughes was not introduced for the purpose of varying, nor did it vary, the terms of the Plan. This testimony showed the circumstances leading to the preparation and adoption of the Plan together with the legitimate reasons for including the stock provisions.

Under Oregon law and other applicable authorities Mr. Hughes' testimony was properly admitted to show the circumstances under which the Plan was made and adopted.

ORS 42.220 provides:

> "42.220 Consideration of circumstances. In construing an instrument, the circumstances under which it was made, including the situation of the subject and of the parties, may be shown so that the judge is placed in the position of those whose language he is interpreting."

In *West* v. *Conrad,* 177 F. 2d 252 (9th Cir. 1949), the court, in passing upon the validity of a lease of property for use as a "Guest House or for any other lawful purpose", which was seemingly in violation of the Housing and Rent Act of 1947 because of the amount of rent specified in the lease, held admissible extrinsic evidence showing that the tenant intended to use the premises for business and not housing purposes. This Court stated (p. 253):

> "* * * Parol evidence is admissible to show the legality or illegality of a contract. * * *"

In *Patterson-Ballagh Corp.* v. *Byron Jackson Co.,* 145 F. 2d 786 (9th Cir. 1944), a California statute similar to the Oregon statute was involved under which it was held (p. 790):

> "Parol evidence then seems here to be admissible for the dual purpose of determining the true consideration and of placing the court 'in the same situation in which the parties found themselves at the time of contracting.' "

In *Aron* v. *Gillman,* 309 N. Y. 157, 128 N. E. 2d 284 (1955), the court stated (p. 163):

> "It is well settled that in construing the provisions of a contract we should give due consideration to the circumstances surrounding its execution, to the purpose of the parties in making the contract, and, if possible, we should give to the agreement a fair and reasonable interpretation (3 Corbin on Contracts, pp. 78-79, 88-91, 115; 3 Williston on Contracts, pp. 1780-1788)."

Appellees did not and do not urge that a lottery conducted for the benefit of charitable organizations or for the promotion of business is therefore not a lottery (Appellants' Br. 53-60). The testimony of Mr. Hughes as to the legitimate business purpose underlying the adoption of the Plan, including the provisions regarding the stock (found by the trial court to be an integral part of the Plan; R. 243, par. 43), was admissible because in the determination of whether or not a particular enterprise involves a lottery, it is necessary to inquire into its purpose, effect, and all its operative facts. Only by having such knowledge can the court determine whether a challenged enterprise contains the evils lottery laws are intended to prevent, and whether the type of chance involved is the kind characteristic of a lottery or is merely a normal business risk in connection with a legitimate enterprise.

The pertinency of an inquiry into business purposes is illustrated by *United States* v. *McDonald* and *United States* v. *Rich* (this brief, pp. 36, 38), where the courts referred to the difference between normal business risk and the type of chance involved in a lottery. See also *Public Clearing House* v. *Coyne,* 194 U. S. 497, 515, 24 S. Ct. 789, 48 L. Ed. 1092 (1904), where the Supreme Court of the United States, in determining that the scheme under consideration involved a lottery, specifically emphasized the absence of legitimate business purposes in the scheme.

Throughout this case the parties proceeded upon the basis that extrinsic evidence was proper for the purpose of showing the circumstances under which the Plan was adopted, the reasons for the inclusion therein of the stock provisions and the manner in which the Plan operated.

Prior to the introduction of Mr. Hughes' testimony, Appellants had introduced numerous exhibits relating to these matters (R. 264). Such exhibits included the following:

> Ex. 2, minutes of the directors' meeting of December 5th and 6th, 1939, at which the Plan was adopted, together with the letter of R. W. Trown, then Comptroller, submitting the Plan to the Board and setting forth the Plan, a summary and explanatory references.
>
> Ex. 55, explanatory letter of Mr. E. C. Sams, then President of the Company, and the other proxy material sent to stockholders in connection with the annual meeting of March 21, 1940, when the Plan was approved by stockholders.
>
> Exs. 74-77, excerpts from the minutes of stockholders' and directors' meetings held in 1935 and 1936 at which it was decided to issue stock to Company associates on advantageous terms.
>
> Ex. 123, the document explaining the Plan and the reason for its adoption, which was submitted to the directors prior to the adoption of the Plan.
>
> Ex. 125, the booklet in which appears the Plan and Trust Agreement as originally issued to participants. The booklet includes an outline of the Plan and sets forth questions and answers relating to it.

Before Mr. Hughes gave his testimony, Appellees had introduced Ex. 227-A (R. 340-344) containing detailed evidence concerning the reasons for inclusion of the stock provisions and Appellants made no objection to this exhibit.

The Statement of Agreed Facts in the Pre-Trial Order also contained extrinsic evidence relating to the Plan to which Appellants made no objection, although machinery was provided in the Pre-Trial Order for such objections to be made on the ground of irrelevancy or immateriality (R. 91). For example, there was set forth in full in the Pre-Trial Order (R. 110-113) a letter dated December 26, 1939, from Mr. E. C. Sams addressed to Managers and Central Office Executives in which Mr. Sams gave the reasons for and purposes of the Plan. It should also be

noted that the charts appearing in paragraphs 38, 39, 40, and 40-A (R. 128-137) of the Pre-Trial Order, dealing with the financial operations of the Plan, were, as paragraph 42-A of the Order recites (R. 145), submitted on behalf of Appellants.

Much of the above evidence was introduced by Appellants in an attempt to establish a foundation to attack the good faith of the directors in adopting the Plan. Appellants stress (Br. 23-32) the fact that officers and directors serving in executive capacities participated in the Plan, derived benefits from it, and that some of them retired with shares of stock. Appellants contend (Br. 27-28) the men in the "governing groups of the Company" possessed "unlimited and arbitrary power over the employment of every participant". Appellants further state (Br. 28) that this "placed such persons in a position in which their duties to participants conflicted with their self-interest or with their interest in the Company." These references in Appellants' brief taken together with their presentation of the case at trial create a definite implication of a charge of bad faith against the officers and directors.

Appellants having introduced evidence in an effort to attack the integrity of Penney Company officers and directors in formulating and carrying the Plan into effect, Appellees had the right to introduce evidence relative to this subject. The trial court properly ruled: "I will consider the testimony of Mr. Hughes with reference to his intentions, at least." (R. 397)

Even if the testimony above discussed had been erroneously introduced, the error was invited by Appellants and will not be reviewed.

In *Hamilton* v. *Hamilton Mammoth Mines, Inc.,* 110 Or. 546, 223 Pac. 926 (1924), the court held there was no reversible error in permitting evidence to be introduced to meet evidence on the same subject introduced by the other party. It explained the basis of its decision as follows (p. 550):

"The only alleged error brought to the attention of the court in the bill of exceptions is a question propounded to the plaintiff by his attorney in rebuttal. This question called for testimony intended to meet the testimony adduced by the defendant in support of defendant's affirmative answer. The defendant cannot, therefore, be heard to complain of the court's action in permitting the question to be answered. The question and answer were probably immaterial, but the error, if any, was harmless. A litigant is not permitted to object to the testimony adduced by his antagonist to meet immaterial testimony theretofore introduced by the former. In any event, the evidence was harmless and the case having been tried to the court, without the intervention of a jury, reversible error was not thereby committed."

Likewise, in *Richardson* v. *Portland Trackless Car Co.*, 113 Or. 544, 233 Pac. 540 (1925), which was an action to recover damages for personal injuries sustained by plaintiff while riding in a motor bus of defendant, the court stated (p. 551):

"Over defendant's objection the court permitted witness to answer the following question:

" 'Supposing a man is standing in the car, in the aisle, near the door, but not against it, and you are running the car a little lively and run into a rough place in the pavement, say you are going at a rate of fifteen miles an hour, and the car lurches to one side; is that a safe place for him to be in?'

"This is not a subject for expert testimony, and was a clear invasion of the province of the jury; but counsel for defendant cannot complain in view of the fact that he had previously asked this witness if there was plenty of room for people to stand in the bus and whether they could stand safely. Error when invited will not be reviewed: Oregon-Washington R. & N. Co. *v.* Spokane P. & S. Ry. Co., 83 Or. 528 (163 Pac. 600, 989, Ann. Cas. 1918C, 991)."

If for any reason the testimony of Mr. Hughes was not technically admissible, nevertheless its admission was

harmless error. The Court of Appeals gives consideration only to such evidence as is competent and material to the issues and therefore the introduction of immaterial or irrelevant evidence in a case tried before a judge without a jury is not reversible error where there is other evidence to support the judgment. See *Bailey* v. *Sears, Roebuck & Co.,* 115 F. 2d 904, 907 (9th Cir. 1940); *Jackson Furniture Co.* v. *McLaughlin,* 85 F. 2d 606, 609 (9th Cir. 1936); *El Paso & S. W. R. Co.* v. *Phelps-Dodge Mercantile Co.,* 75 F. 2d 873, 879 (9th Cir. 1935); *Bodkin* v. *Edwards,* 265 Fed. 621, 623 (9th Cir. 1920); *Cascaden* v. *Bell,* 257 Fed. 926, 930 (9th Cir. 1919).

The record in the case before this Court is replete with evidence apart from Mr. Hughes' testimony which conclusively establishes the validity of the Profit-Sharing Retirement Plan and supports the judgment of the trial court.

All question as to the admissibility of Mr. Hughes' testimony is put at rest by Rule 61 of the Federal Rules of Civil Procedure, which provides in part:

> "The court at every stage of the proceeding must disregard any error or defect in the proceeding which does not affect the substantial rights of the parties."

In *Ryno* v. *United States,* 232 F. 2d 581, 584 (9th Cir. 1956), this Court stated the well established rule that:

> "In reviewing a judgment in an appellate court, the burden is on the plaintiff in error to show that error in the admission of testimony was prejudicial. *Simpson* v. *United States,* 9 Cir., 289 F. 188, 191. No such showing has been made here."

The Appellants have not shown and cannot show how the testimony of Mr. Hughes could be prejudicial in any way.

IV. APPELLANTS' CONTENTION THAT THERE SHOULD BE A RESULTING TRUST IN FAVOR OF 1940 AND 1941 PARTICIPANTS CANNOT BE SUSTAINED.

(See Appellants' Specifications of Error Nos. 5 and 7.)

A. The Manner of Acquisition of the Stock by the Trustee Cannot Entitle Appellants to any Relief.

In an attempt to support their argument for a resulting trust, Appellants make the contention that the 200,000 shares of stock were purchased by the Trustee with the earnings and compensation of 1940 and 1941 participants (Br. 3, 70-79; Specification of Error No. 5, Br. 18).

Their contention is urged, not to support their assertion that the stock provisions of the Plan are invalid, but in support of the relief they claim should be granted if their contention of illegality should be upheld. Unless the Court should determine that the Plan is invalid, the resulting trust discussion in Point II of Appellants' brief is irrelevant.

Appellants' statement of the facts in support of their resulting trust argument contains assertions that are inaccurate or involve unwarranted implications.

Appellants assert that the earnings and compensation of the former managers and management staff members "were used to purchase 200,000 shares of the stock of J. C. Penney Company (later split 3 for 1)" (Br. 3). This assertion is not accurate. The stock was purchased with the proceeds of a loan to the Trustee made by the Continental Bank, and the loan was repaid out of Fund assets by December 29, 1941 (R. 226, par. 19, R. 229, par. 23).

The Fund assets so used originated in four sources: (1) participants' contributions; (2) the Company's 2% contribution measured by salaries; (3) the Company's 6% of profits contributions; and (4) dividends on the

200,000 shares of Company stock purchased by the Trustee. As the trial court found and concluded, once these moneys passed into the hands of the Trustee they lost their separate identity and became assets of the Fund. The use of Fund assets to repay the loan was in accordance with the Plan and Trust Agreement (R. 229, 230, pars. 23, 25).

The Plan (Ex. 125, Art. 5, pp. 24, 25) and the Trust Agreement (Ex. 125, Art. Fourth, p. 39) specifically authorized the Trustee to borrow $5,700,000 from Continental Bank to provide funds to pay the Penney Company for the 200,000 shares of stock and to pledge as security for the loan all assets in the Fund including the Company stock. The Trust Agreement (Ex. 125, Art. Fourth D, p. 40) provided that all dividends on such shares of stock and all contributions received from the Company or from participants should be paid to Continental Bank as received on account of the principal and interest of the loan, except a sum not to exceed $150,000 to be retained by the Trustee as working funds.

Such loan was in fact negotiated on August 1, 1940, and, as stated above, by December 29, 1941, it was repaid in full by the Trustee out of funds in its possession (R. 229, par. 23). While the loan was being repaid, every dollar of the Company's 6% of profits contributions and every dollar of participants' personal contributions were credited to their account (R. 235). As the trial court found (R. 230), use of the Trust Fund assets to pay the loan, interest and expenses did not interfere with making all credits to the accounts provided for by the Plan in strict accordance with the provisions thereof. The trial court further found (R. 230) that at all times from August 1, 1940, through December 31, 1953, the resources of the Trust were sufficient to satisfy the credits of all participants. Appellants agreed in the Pre-Trial Order (R. 177, par. 80) that each participant whose participation ceased prior to reaching retirement status received from the Trust an amount equal to the aggregate of his own contributions and in addition

the other credits from the Fund to which he was entitled under the Plan.

The repayment of the loan had nothing to do with covering the cost of the 200,000 shares of stock on the books of the Fund. As explained below, such cost was to be covered ultimately by the earliest dividends on such shares and by the Company's 2% contribution measured by salaries.

Appellants assert (Br. 9, 10) that the Penney Company itself assumed no liability with respect to payment of the stock loan, nor did it guarantee its payment, nor did it execute a hold harmless or indemnity agreement with the Trustee or with the Bank.

It is not true that the Penney Company assumed no liability with respect to the loan. The loan agreement here referred to was executed July 25, 1940, between Continental Bank, the lender, Chase National Bank, as Trustee, and the Penney Company. The sixth paragraph thereof included in part the following provisions:

> "Penney hereby agrees with the [Continental] Bank that, so long as said note evidencing the said original loan shall be unpaid in whole or in part or there shall be any other outstanding and unpaid indebtedness of the Trustee to the Bank, Penney will, annually and promptly, make the contributions, provided to be made by it under the Plan as now in force, in cash at or before the times, in the manner and in the amounts so provided in said Plan, and that Penney further will not reduce the amount of its contributions, provided to be made by it under the Plan as now in force, below the amounts which are required to be contributed by it, from time to time, under the Plan as now in force, and that Penney further will not discontinue making the contributions, provided for under Section 6(a) of the Plan as now in force, regardless of the amount of the 'Reserve for Retirement account' and will not exercise any rights, granted to it under Section 15 of the Plan as now in force, to decrease or dispense with any Company contribution called for under the Plan as now in force or to substitute any form of stock or securities for cash contributions."

(R. 373, 374; Ex. 210)

In addition, the Trust Agreement (Ex. 125, Art. Fourth G, p. 41) reads as follows:

> "The Company shall not consent to, or take any steps to accomplish, the termination or discontinuance of the Plan or this agreement of trust at any time at which there shall be any outstanding indebtedness or liabilities of the Trustee to the Bank in connection with its loans to the Trustee as herein provided."

In other words, until the loan was repaid there was an absolute obligation on the Penney Company to maintain the Plan in effect and to continue its contributions called for by Art. 6(a) of the Plan in an amount equal to 2% of the aggregate regular salary paid to all employees receiving compensation during the preceding year and the contribution called for by Art. 6(b) in the amount of 6% of the Company's net profit for the prior year in excess of 15% of the common stock book value of the Company.

Appellants assert (Br. 10, 11)—"During this time [prior to the repayment of the loan] when participants' funds were completely utilized for the payment of the loan used to purchase the shares, such funds were not available for other investments for the benefit of participants." Use of the assets of the Fund to repay the loan was strictly in accordance with the terms of the Plan to which all participants had agreed (R. 231). Moreover, no participant, however quickly he separated from the Company after the adoption of the Plan, failed to receive at least all his personal contributions plus his share of the Company's 6% of profits contribution for every full year in which he participated in the Plan. The example used by Appellants is the case of Mr. McAlpine, who separated on August 31, 1941. Mr. McAlpine contributed $4,278.38 and on separation received $4,635.05, an increase of $356.67, or 8% of his personal contributions (Ex. 292). Due to the fact that Mr. McAlpine separated in August, rather than at the end of the year, under the terms of the Plan he did not participate in the

Company's 6% of profits contribution for 1941 (Ex. 292). After the cost of the 50,000 shares of stock was covered in September, 1941, explained below, dividends were credited to the Dividend Account in which all participants separating after September 1941 shared. The date September 1951 (Appellants' Br. 12, 3rd line from bottom) is incorrect.

Appellants assert (Br. 11, 12) that while the loan was being repaid during 1940-1941, the participants bore the entire risk in the event the Bank foreclosed on the stock held by the Trustee and that a vast discrepancy existed between the credits absolutely vested in and due participants and the cash held by the Trustee. Since the principal on the note was not due until August 1, 1943 (Ex. 211), the possibility of such foreclosure occurring during 1940 or 1941 was purely fanciful. Furthermore, as in the case of a bank, the Trustee maintained on hand sufficient cash to meet all anticipated withdrawals (Ex. 292, R. 137), and no importance attaches to the circumstance that the Trustee did not maintain sufficient cash on hand to meet its obligations to all participants "had they chosen voluntarily to withdraw, or if the Plan had failed for any other reason."

The Plan, the Trust Agreement, the Loan Agreement (Ex. 210), and Note (Ex. 211) contained provisions to insure that the use by the Trustee of the moneys received by it to repay the loan would not interfere (and in fact it did not interfere) with the Trustee's ability to make whatever payments might be required in accordance with the credits to the various accounts under the Plan to participants who might leave the employ of the Company in the early years of the Plan. Those provisions, in substance, were as follows (R. 228, par. 21):

(1) The Trustee was authorized by the Trust Agreement, Article Fourth E, and the Note that it delivered to the Continental Bank to retain, out of the cash received by it, $150,000 for working funds.

(2) The Loan Agreement, paragraph 2, provided that the Bank at any time after the principal of the loan had been reduced to $4,500,000 or less would make a new loan to the Trustee up to $500,000 and would also release to the Trustee up to 10,000 shares of Penney Company stock.

(3) Under the terms of the Plan, Article 5, and Trust Agreement, Article Fourth B, Eighth A, the Trustee was authorized to reborrow from the Continental Bank, after any partial repayment of the original loan, up to $5,700,000 (including any unpaid balance of the original loan) and, after complete repayment of any loans from the Continental Bank, to borrow without restriction on the security of the assets in the Fund such amounts as might be required to carry out the purposes of the trust.

The Trustee paid the loan down to $4,200,000 on the very day that the loan was made. It did not at any time become necessary for the Trustee to borrow additional funds from the Continental Bank or from any other source. Both prior and subsequent to the repayment of the loan, the provisions set forth above constituted a resource of the Fund available to the Trustee to obtain additional cash if any had been necessary to pay the credits of participants withdrawing from the Plan. (R. 228, par. 21)

That the cash assets of the Trustee were substantially below the amounts that would have been due all participants had their participation ceased on or prior to December 29, 1941, resulted in no substantial risk to participants. On December 29, 1941, when the Trustee completed repayment of the loan of $5,700,000, the Trustee held in addition to $389,565.61 cash (R. 137) the 200,000 shares of Penney Company stock free and clear. Significantly, Appellants omit to mention that the stock so held then had a market value of approximately $15,400,000 (R. 119). Participants' credits, less withdrawals by participants prior to December 29, 1941 (R. 137), then totalled $4,888,306.22 (R. 138).

Thus, if, as suggested by Appellants, all participants had resigned or died on December 29, 1941, the Trustee would have had to meet obligations of $4,888,306.22. With $389,565.61 (R. 137) cash then on hand, the Trustee would have had to borrow the difference, or, $4,498,740.61. The Trustee could easily have done so on the security of the Penney stock then worth approximately $15,400,000 (R. 119). Of course no such contingency ever arose. It puts a ridiculously excessive strain on the imagination to visualize circumstances under which 1,731 associates of the Penney Company (R. 167), store managers and associates in the central and branch offices, would have resigned or died on the same date.

At all times from August 1, 1940, through December 31, 1953, the last full calendar year for which figures are set forth in the Pre-Trial Order, the resources of the Trust were overwhelmingly sufficient to satisfy the credits of all participants. On August 1, 1940, the date the Trustee paid $5,700,000 for the 200,000 shares of stock, their market value was $80 per share, or $16,000,000 (R. 229), thus providing on that date a buffer of over $10,000,000 of security. Between August 1, 1940, and December 29, 1941, the date when the loan was fully repaid, the price of Penney Company stock ranged from $73 to $92 per share (R. 119), the stock thus having a value of between $14,600,000 and $18,400,000 (R. 229, par. 22).

While Appellants seem to have confined to the period between August 1, 1940, and December 29, 1941, their fears concerning the alleged discrepancy between credits to participants and cash held by the Trustee, it may be well to point out that no question of the solvency of the Plan can be raised during any period subsequent to December 29, 1941. At no time between that date and January 16, 1946, when the stock was split three-for-one, did the price of Penney Company stock fall below $57 per share; since that split the stock has never been below $36 per share, or $108 per original share (R. 119).

On December 31, 1953, participants' credits amounted to $65,636,598.36. On the same date the assets of the Fund, exclusive of the 483,754 shares of Penney Company stock, consisted of cash on hand, receivables, government bonds, and deferred annuities amounting to $63,286,595.59. The difference of $2,350,003.77 represents the remaining uncovered cost of the original 150,000 share block of stock to be covered by the Company's 2% contribution measured by salaries. (R. 147, 241)*

The Company has had an unbroken profit and dividend record from the time of its incorporation in Delaware in 1924 (R. 241, par. 39). Its predecessor, the Utah corporation, incorporated in 1913, had an unbroken profit record except for the year 1920 (Hughes, R. 375, 376). Sales for 1913 were $2,637,293.72 (Ex. 154), increasing steadily over the years to sales of $304,539,325.64 and net income of $16,230,608.84 in 1940 (Ex. 145). For the year 1950 (Ex. 155—the last annual report in evidence) sales were $949,711,735.43 and net income was $44,930,816.28.

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* Appellants assert that each participant is required to contribute annually to the Plan one third of his compensation (as defined in the Plan) exclusive of regular salary (Br. 7). This was true only for the years 1940 and 1941. Contributions by participants from their 1939 compensation were not required but were voluntary up to 33⅓%. Because of increased Federal Personal Income taxes, the percentage of each participant's contribution for 1942 and subsequent years was reduced to 20% of his annual compensation (R. 225, par. 15; R. 233, par. 30A).

Appellants assert (Br. 7) that the Company is required annually to contribute an amount equal to 6% of the Company's net profit for the prior calendar year in excess of 15% of the common stock book value of the Company. This is correct for the period through 1949 except that net profit was computed before the deduction of this contribution. For each of the years 1950 through 1953 the profit sharing contribution was changed to 2% of the Company's net profit before Federal taxes and before the Company's contribution to this Plan and to its Thrift Plan. (R. 234)

In terms of its ability to meet its obligations, the Plan is and at all times has been fully solvent. Realistically considered, there has been no risk to participants.

In analyzing Appellants' argument that the stock was bought with participants' funds, it is necessary to bear in mind that the stock provisions of the Plan have a two-fold function.

First, the stock is an asset of the Trust Fund. Dividends received on it are, in effect, income of the Fund. They are credited to the Dividend Account for the benefit of all participants. Because of such dividends, participants leaving the Company on retirement or earlier separation receive larger annuities. The Plan, instead of including the provision for purchase of the stock, might have provided for trust assets to be invested exclusively in Government bonds. That would also have been a sound investment, but the rate of return would have been low. By enabling the Fund to purchase shares of Penney stock at $50 a share below the market price, the Company provided the Fund with a safe, and at the same time lucrative, investment. As already pointed out (Point I, B, *supra*), against an original cost of $6,000,000, credits to the Dividend Account for the benefit of participants have amounted in the aggregate over the years to more than $17,000,000.

Second, the Plan provides for the distribution to participants attaining retirement status, out of the Company stock held in the Fund, of a number of shares determined in accordance with the Plan formula. The shares are intended to supplement the annuities received on retirement and thus furnish an additional source of security for participants in the later years of their lives.

In considering the stock feature of the Plan it is necessary to distinguish between the matters discussed in subparagraphs (i), (ii) and (iii) following:

(i) The use of trust assets to repay the loan used to acquire the stock.

Purchase of the Penney stock by the Trustee constituted investment of a portion of the Fund. The Trustee, in the first instance, borrowed the money to pay for the stock. It then used trust assets to repay the loan. This transaction did not differ in principle from an investment in Government bonds. Like such an investment, it produced income for the Fund but with a higher rate of return. Whether the trust assets had been invested in Company stock or in Government bonds, there would have been no difference in the amounts credited in accordance with the Plan to the accounts of individual participants from the Company's contribution based on profits and from participants' personal contributions.

(ii) The credits to the accounts of the participants.

It is the credits to participants' accounts which determine the amount of cash or annuities they receive on retirement or other separation (R. 238, pars. 32, 33, 34, Ex. 125, 29-31). The amounts of the credits provided by the Plan to be made to their accounts were not affected in any way either by the investment of trust assets in Penney stock (except advantageously in view of the lucrative yield on that investment) or by the manner in which the cost of the stock was covered on the books of the Fund.

(iii) The manner in which the cost of the stock was to be covered on the books of the Fund.

Since the Trustee was to purchase the stock for cash (i.e. at a cost of $30 per share, less adjustment for dividends of $1.50 per share paid by the Company between January 1 and August 1, 1940, which were to be considered as a receipt of dividends in that amount), it was necessary to include in the Plan provisions whereby the cost would be covered on the books of the Fund so that shares might be distributed to retiring participants without charge (Ex. 125, Art. 5, pp. 24, 25, Art. 10, pp. 29, 30). These provisions were separate and distinct from those for the repayment of the loan.

As provided by Article 7(c) of the Plan, the original 200,000 shares of Penney Company stock were separated in the Fund's accounts into two blocks—one of 50,000 shares and one of 150,000 shares with actual cost applied to each block, after the dividend adjustment provided for under Article 5 of the Plan (Ex. 125, p. 26, R. 235-237).

The $1,500,000 cost of the original 50,000 share block was to be covered by the Company's 2% contribution measured by salaries under Article 6(a), and by the earliest dividends (including the $300,000 adjustment for dividends paid between January 1 and August 1, 1940) on all of the 200,000 shares of stock, after payment from such dividends of interest on the money borrowed to purchase the stock and incidental Plan expenses not borne by the Company (Ex. 125, Art. 7(d), (e), p. 26, R. 235-237).

The $4,500,000 cost of the original 150,000 share block was to be covered solely by the annual 2% of salary contribution through the medium of the Reserve for Retirement Account to which account such contributions were credited annually after the cost of the 50,000 share block was covered. After the cost of the 150,000 share block is covered, the 2% of salary contribution will terminate. (Ex. 125, Art. 6(a), p. 25, R. 237, par. D.)

It was because of these specific provisions in the Plan with regard to application of the 2% of salary contribution and the earliest dividends on the 200,000 shares that no participants received credits to their accounts from them. Participants were given full information with regard to these provisions, not only in the Plan but also in the Questions and Answers and Outline (Ex. 125, p. 26, 5, 12, 13), and agreed to them (R. 231, par. 27).

The Plan was operated precisely in accordance with the provisions to which we have referred (R. 237, pars. D, E).

The $1,500,000 cost of the 50,000 share block was entirely covered by September, 1941 by the Company's contribution for 1940 measured by salary under Article 6(a) of the Plan, amounting to $102,206.97, and dividend credits of $1,397,793.03. Company contributions measured by salary

under Article 6(a) of the Plan for succeeding years were and are being credited to the Reserve for Retirement Account to cover the $4,500,000 cost of the 150,000 share block. As at December 31, 1953 the Reserve for Retirement Account amounted to $2,149,996.23, leaving a balance of $2,350,003.77 to be received from the Company in the form of its annual contributions under Article 6(a). Dividends received by the Trustee by September, 1941, not needed in covering the cost of the 50,000 share block, and exclusive of the dividends of $40,239.60 (R. 138, 5th column) used to pay off interest on the loan and incidental expense not borne by the Company, and all dividends received by the Trustee thereafter were credited to the Dividend Account (R. 237, pars. D, E; R. 147).

It is clear that the entire cost on the books of the Fund of the original 200,000 shares of stock will be covered solely by payments made by the Company to the Trustee which, under the terms of the Plan, are to be applied exclusively for that purpose. Earliest dividends, together with the Company's contribution measured by 2% of salary, were required to be and were applied by the Trustee to the cost of the original 50,000 share block until that cost was entirely covered, and thereafter the Company's 2% of salary contribution has been and must be, by the specific terms of the Plan, applied to the cost of the original 150,000 share block. No contributions by participants have been applied to the cost of covering such stock. The Company has paid and is paying the cost of the stock. No trust can result in favor of Appellants on their theory that their funds were used to cover the cost of the stock.

The general propositions of trust law cited by Appellants (Br. 64-66) lend no support to their argument that there should be a resulting trust in their favor. We have shown that Appellants have not paid any part of the cost of the stock. If, as seems inconceivable, the Court should hold the Plan invalid, then, in view of the fact that the entire cost of the stock is being paid by the Company, additional court proceedings would be necessary

to determine the proper disposition of the stock now held in the Fund.

Appellants' cases (Br. 62-64) involve professional gambling, having to do with bets on races and other sporting events, and are not in point. In each case the recovery was only the dollar amount advanced by the bettor to the stakeholder. In the *Bamman* case (Br. 63), the court specifically stated that the bettor could never recover winnings. Appellants' characterization of the 200,000 shares of stock as a "prize" (Br. 53) would by itself preclude Appellants from recovery of any of these shares under the authorities they have cited. Appellants have already received back not only every dollar of their own personal contributions but other benefits in addition.

B. Company Contributions to the Trust Constitute Deferred Compensation to Participants Only Under the Conditions Provided by the Plan.

Appellants (Br. 70-79) seek to strengthen their argument for a resulting trust by contending that all Company contributions constituted current compensation to participants. They advance the following propositions:

> "At the end of each year as such contributions (Company contributions under Article 6(a) and 6(b) of the Plan) are accrued, they become vested compensation earned by participants (Br. 77).
>
> "Thus, under state substantive law and under federal and state tax law, all the funds used by Trustee to purchase the Penney stock were the earnings of participants at the end of each year in which accrued" (Br. 79).

Appellants' propositions are not in accord with the law or the facts.

The Company contributions constitute deferred compensation subject to the terms and conditions of the Plan. No participant had a right to receive any of such compen-

sation either in cash or in stock except in accordance with the Plan's conditions (R. 252, 253, pars. 16-18). All moneys used to pay the loan with which the stock was purchased had come into the hands of the Trustee to be used solely in accordance with the Plan and Trust Agreement and retained no separate identity except as assets of the Fund (R. 230, par. 25; this brief). Calling the funds used by the Trustee to repay the loan "earnings of participants at the end of each year in which accrued" (Br. 79) cannot remove the conditions under which they came into the Trust Fund, or vary the terms of the Plan governing their disposition.

Appellants in their brief (77) state:

> "The profit-sharing contribution under Section 6(b) of the Plan and the 2% of aggregate salaries contributions under Section 6(a) of the Plan are 'treated as though they were in the Fund at the end of the year in which * * * earned.' 'Company contributions are credited to participants' accounts on this accrual basis' (R. 146)."

This is not an accurate statement of what appears in the Record at p. 146, and is misleading. The Record there states (par. D(ii)) that the Company contributions under Article 6(b) of the Plan

> "are upon an accrual basis, that is to say, Company contributions have been treated as though they were in the Fund at the end of the year in which were earned the profits upon which such contributions were based rather than in the subsequent year in which such contributions were paid to the Trustee."

The statement at R. 146 has no reference to the year in which contributions were "earned" by any participants, but refers solely to the year in which were earned the Company profits, upon which the Company contributions under Article 6(b) were based.

Under the terms of an employees' benefit plan the participants' interests in the assets held by the trustee may

remain contingent prior to a specified date or prior to their reaching retirement age.

Rev. Rul. 33, C. B. 1953-1, 267, 280, provides as follows:

> "(b) *Vested rights in employer's contributions.*—The Code does not require that an employee be granted immediate vested rights in his employer's contributions as a condition for qualification of a plan. Various provisions for vesting are in use, ranging from complete and immediate vesting through different forms of graduated vesting, upon completion of stated service or participation requirements, to no vesting until attainment of normal or stated retirement age."

A case closely in point is *Schaefer* v. *Bowers,* 50 F. 2d 689 (2d Cir. 1931). The plaintiff, Schaefer, an employee of Standard Oil Company of New Jersey, became a participant in a stock subscription plan inaugurated by that company on December 30, 1920 for a period of five years. The Plan was an exempt employees' trust under the Internal Revenue Code. The plan provided that an employee might contribute to the fund under the plan up to twenty per cent of his pay to which the company would add one-half. Trustees were to receive such joint contribution and from time to time purchase shares of the company's stock. Title to the shares was to be in the trustees, but the shares were to be credited on the trustees' books to the employees in proportion to the joint contribution. Judge Learned Hand, in describing the Plan, stated (at p. 690);

> "(1) An employee might remain in the service of the company and withdraw from the fund. In that case he got back only his own deposits with interest, or if the trustees so decided, an 'equivalent thereof' in shares at their average cost. (2) He might leave the employer's services voluntarily, or be 'discharged for good cause (of which the trustees shall be the sole judges).' In either event he should also have only his money back with interest, or 'at the option of the trustees,' an equivalent in shares. (3) He might be retired or quit 'on account of total disability or for other satisfactory cause (of which the trustees shall

> be the sole judges),' or he might be discharged through 'no fault of his own.' In either of these cases he was to receive the full amount of the shares to his credit at the time. If he died, his successors had the same rights.''

The plaintiff had made contributions during the five year period and received certain shares of stock as his distribution. The issue involved was the manner in which the stock was to be treated for income tax purposes. The court stated (p. 691) that this issue ''turns upon the character of the employee's interest in the fund before distribution.'' The plaintiff's argument was to the effect that ''when the trustees bought shares of stock by means of the joint contribution of employer and employee, they became his in equity'' and were his property at that time. The court rejected this argument, stating in part (p. 691):

> ''When shares were unconditionally allocated to an employee under a kindred scheme, we held that they were taxable when credited to him (*Rodrigues* v. *Edwards,* 40 F. (2d) 408), but here the employee's right to anything but his own contribution was conditional until the period expired. * * *
>
> ''We rely first upon the fact that the right, whatever it was, was conditional on the employee's continuance in the company's service for five years. The plaintiff answers that this was a condition depending wholly upon his own volition, and cannot properly be regarded as a condition at all. We cannot agree. He might be discharged, and the trustees were to be the 'sole judges' whether or not it was for 'good cause.' It is idle to say that a man subject to discharge for reasons resting in the decision of a third person, voluntarily abandons the service, because his discharge presumably depends upon his own conduct. He may prove incompetent, or arouse the displeasure of his employer for reasons of which he could not anticipate such a result. Even though the decision of the trustees was subject to eventual review in cases of plain abuse, the occasions for its lawful exercise might be such as he could not control or foresee.
>
> ''Moreover, even if it can be thought that any discharge is voluntary, still his rights changed upon dis-

tribution. Until then, his interest was charged with the obligation to remain; that is as true a condition as though his employment did not rest in his pleasure. Practically it might prove onerous; he might find it much to his advantage to go elsewhere, but his decision to do so was clogged by the fact that he would lose his shares. Certainly he had not that untrammelled dominion over property so limited which he has over property in general."

The court further stated (p. 692):

> "Therefore, we think that when the shares were distributed at the close of the five-year period, the plaintiff got for the first time the income which had theretofore been accumulating, conditionally upon his continued service and the company's continued purpose to complete. *Appeal of Lister,* 3 B. T. A. 475. Until then it was uncertain whether he would ever receive the shares; they had become his only provisionally."

The decision in *Schaefer* v. *Bowers, supra,* was followed in the case of *Ralph H. Jackson,* 40 B. T. A. 1094 (1939) which involved a similar trust with respect to shares of stock of the Carborundum Co. created by that company as a part of a profit-sharing plan for its employees. In the *Jackson* case, the Board of Tax Appeals stated (p. 1099):

> "In any event, we think that *Schaefer* v. *Bowers, supra,* disposes of petitioners' contention. In that case, the employee's ultimate receipt of the stock depended on his continuance in the employ of the company for a definite period of time. The situation here is the same, for the plan as set out in the trust instrument provides that the participating employee may make monthly contributions only up to a certain amount, and that if his employment is terminated he will receive his contributions back. In other words, before he can get the stock, he must work until the sum of the maximum payments he is permitted to make out of his wages equals the purchase price of the stock he has agreed to buy. It is this feature which, as the court held in the *Schaefer* case, differentiates peti-

tioners from ordinary purchasing investors and makes them taxable under Section 165."

See also *Commissioner of Internal Revenue* v. *Texas Pipe Line Co.*, 87 F. 2d 662 (3rd Cir. 1937) and *Cravens* v. *Climax Engineering Co.*, 40 F. 2d 359 (8th Cir. 1930).

C. It Would be Inequitable to Permit Appellants to Recover.

In view of the presentation which we have hereinabove set forth, we believe it inconceivable that the Plan would be held to be invalid insofar as it relates to Penney Company stock or otherwise. The issue whether a resulting trust should be declared in favor of the Appellants or any other participants will therefore not be reached.

In any event there is no merit to Appellants' Specification of Error No. 7 (Br. 18). It would be inequitable to allow Appellants to recover in this proceeding:

(1) Appellants' funds were not used to cover the cost of the stock (Point IV, A *supra*).

(2) The loan was repaid with moneys retaining no separate identity except as assets of the Fund, and which were the property not of any participant, but of the Trustee, subject only to the terms of the Plan and Trust Agreement (R. 230, par. 25; R. 252, par. 16).

(3) The Company sold the 200,000 shares of Penney stock to the Trustee for a sum approximately $10,000,000 less than its then market value, from which stock substantial dividend credits were received (R. 225, par. 17; R. 229, par. 22).

(4) The Plan constituted a contract between the Company and Appellants which was fully executed and performed as to all of its terms (R. 252, par. 15; R. 246, par. 51; R. 247, par. 53; R. 242, par. 41).

(5) The Plan had been in continuous operation for over eleven years before any attack was made on its validity (R. 248, par. 54).

(6) The Penney Company made its original and subsequent contributions to the Plan on the basis of acceptances signed by participants and upon the basis of the validity of the Plan (R. 248, Par. 55).

(7) Appellants have accepted and retained large benefits distributed in accordance with the terms of the Plan, including large contributions by the Penney Company and dividends on Penney Company stock (R. 239, par. 36).

The trial court made the following Finding of Fact:

> "It would be highly inequitable to permit plaintiffs Wells and Albertsen to recover in this proceeding, either on their own behalf or on behalf of the class for which they are suing" (R. 249, par. 58).

and thereupon properly concluded:

> "The Court has already found that the Plan is valid, but even if by some technical construction the Plan was found to constitute a lottery or other illegal scheme, it would, under all the facts and circumstances herein, be highly inequitable to permit plaintiffs to recover either on their own behalf or on behalf of the class for which they are suing.
>
> "Neither plaintiffs nor any member of the class whom they represent is entitled to receive any shares of the Penney Company stock held by the Trustee of the Penney Company Retirement Plan" (R. 253, pars. 19, 20).

In their Specification of Error No. 8 (Br. 18, 19) Appellants' Counsel assert that the District Court erred in failing to award them reasonable attorneys' fees, to be a lien upon the shares of stock they seek to recover for those whom they represent. Since the trial court entered judgment in favor of Appellees, this issue was never reached in that court. In any event this matter of attorneys' fees involves an issue solely between Appellants and their attorneys and does not concern Appellees (R. 323-325).

CONCLUSION.

The judgment of the District Court should be affirmed in all respects.

Respectfully submitted,

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